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BOOK REVIEWS

Preparation and Certification of Financial Statements

By B. Bernard Greidinger. THE RONALD PRESS COMPANY, New York, N. Y., 1950. Pages: vii + 408; $6.00.

In the preface to this volume the author has the following statement:

> "The book has been written with two specific purposes in mind: first, to provide a suitable text book for college courses devoted to a study of current problems in the preparation of informative and dependable financial statements; and second, to provide a useful reference work for those actively engaged in the preparation, certification, or use of financial statements for investment, credit, and periodic reporting purposes."

The author also states that primary emphasis has been placed on the most acceptable methods of presentation and disclosure and that the basic principles and practices applicable to the items in the balance sheet and profit and loss statement are set forth and demonstrated by illustrations selected from current annual reports. This is a fair statement of Mr. Greidinger's actual accomplishment.

The index of contents lists the names of the fifteen chapters of which the book consists, and refers to supplemental indexes in the back of the book, one about the corporate reports of which comments have been made and the subjects of such comments, the other a subject index which appears to be very complete.

Although the subject index may be resorted to as to any item concerning which the reader desires information, it appears to this reviewer that the content index could have been helpfully expanded for the purpose of giving a brief summary of the topics discussed under each main heading. For instance, the first chapter is devoted to "Development of Informative and Dependable Financial Statements". This chapter includes intelligent discussion of corporate financial statements prior to 1933, the prior and subsequent influence thereon of the New York Stock Exchange, American Institute of Accountants, and the Securities and Exchange Commission, the financial statements required at registration with the Securities and Exchange Commission, a description of Securities and Exchange Commission regulation S-X, and reference to accounting releases, official decisions, and deficiency letters of the S.E.C. Comments are also included regarding the enforcement by the S.E.C. of financial reporting requirements and the liabilities of independent public accountants. The chapter covers nineteen pages but the content index gives no indication of what the reader may find therein. A similar comment appears applicable to each chapter. Salability of the book would probably have been enhanced if a prospective buyer could tell by a quick glance at the contents the subjects to be found therein.

The content of the book is worth while and ably developed. Discussion of current assets in chapter 2, for instance, starts off with a definition of current assets and then discusses the individual items ordinarily found therein with an informative comment as to each, showing examples of current practice with respect thereto, as well as unacceptable prac-

(Continued on page 376)

THE NEW YORK
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EMANUEL SAXE, *Managing Editor*

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New York State Rent Control—1950

By MORTON GELLER, C.P.A. *and* BETTY R. GELLER, C.P.A.

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BETTY R. GELLER, C.P.A., joined the Society in 1948, and was formerly a member of its Committee on Municipal and Local Taxation. She is an alumna of The City College of New York.

Mr. and Mrs. Geller are engaged in general practice as certified public accountants in New York City. This paper was presented by Mr. Geller at a technical meeting of the Society held at the Engineering Societies' Building on May 2, 1950, under the auspices of the Committee on Real Estate Accounting.

TENNYSON wrote, "In the spring a young man's fancy lightly turns to thoughts of love."[1] In recent years with the advent of spring it seems that the public's thoughts turn to rent control legislation. This year we are again faced with a set of new rent rules. The most marked changes in the latest laws are in the field of residential rent controls.

A brief summary of preceding rent controls would not be amiss at this point. The controlled residential areas of the entire country were regulated solely by federal controls beginning in 1942[2] and continuing until 1947.

Due to the contraction[3] of Federal rent regulations effected by the Housing and Rent Act of 1947,[4] a number of cities throughout the country enacted local legislation to prevent what municipal authorities believed would be an undesirable outbreak of rent increases and evictions.[5] New York City was one of the first municipalities to enact local legislation recontrolling federally decontrolled hotels, apartment hotels and rooming houses,[6] and establishing a system of eviction controls for apartments and similar accommodations,[7] as well as other rent rules.[8]

1 Alfred, Lord Tennyson, "Locksley Hall".

2 56 Stat. 23 (1942); 50 USCA App. Sec. 901-946; Emergency Price Control Act of 1942, Public Law 421, 77th Congress, 2nd Sess.

3 Decontrol of hotels and other accommodations and elimination of eviction controls. See *infra* note 4.

4 Public Law 129, 80th Congress, 1st Sess. (June 30, 1947); 61 Stat. 193; 50 USCA App. Secs. 1881-1906.

5 Friedlander and Curreri, Rent Control, (1948) Sec. 63.

6 Local Laws 54 for 1947, New York City Administrative Code, Sec. U 41-6.0.

7 Local Law 80 for 1947, New York City Administrative Code Sec. U 41-7.0.

8 New York City Administrative Code Secs. U 41-8.0 and 9.0.

The enactment of the Housing and Rent Act of 1949[9] with its provision for maximum rents at levels "which will yield to landlords a fair net operating income"[10] led to hasty enactment of additional New York City controls.[11] The new law which became effective on October 7, 1949, amended Section U41-7.0 of the New York City Administrative Code and provided that it was unlawful for any person to demand or receive a rent in excess of that collected on March 1, 1949, unless the City Rent Commission authorized the collection of a higher rent. The net effect of this law was that since its enactment, according to the New York City Rent Commission Counsel, only 69 increases were approved.[12]

On December 29, 1949, the Court of Appeals declared this New York City rent legislation void.[13] To protect the tenants of New York City from the imposition of retroactive rent increases, (which the Regional Housing Expediter stated totaled 189,291 in the State of New York on May 1, 1950),[14] the first law enacted by the 1950 New York legislature[15] validated the New York City rent and eviction controls until May 1, 1950. In approving this temporary legislation on January 10, 1950, Governor Dewey portended coming state controls.[16] He said, "The shifting scenes of federal control, city control, invalidating of city control and new city control present a grim comedy of errors of which the people of the City of New York have been the victims." At the same time the Governor requested the Temporary State Commission to Study Rents and Rental Conditions[17] to prepare legislation on the entire subject of residential controls.

On March 8, 1950, the Governor in a special message[18] to the Legislature recommended the enactment of a State residential control law in place of federal and city rent legislation. The enactment of State Residential Rent Laws came in the final hours of the legislative session after a hectic two-week period of parliamentary maneuvering.[19] On March 29, 1950, the Governor approved the administration sponsored Stephens Bill,[20] which was drafted by the Temporary State Commission on Rents and Rental Conditions,[21] but which included eight amendments inserted at the last moment in an attempt to win opposition votes.[22]

Since 1946,[23] New York State has had in effect a so-called "standby"[24] residential rent control law. Because this law was never actually used, al-

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9 Public Law 31 of 1949, 81st Congress.

10 Sec. 204(B) of Federal Housing and Rent Act of 1949, see note 9, *supra.*

11 Local Law #73 for 1949.

12 New York Herald Tribune, March 15, 1950.

13 *F. T. B. Corp.* v. *Goodman*, 300 N. Y. 140, 89 N. E. 2nd 865 (1949).

14 New York World Telegram, New York Times, May 1, 1950.

15 Chapter 1 of Laws of 1950, New York State.

16 McKinney's Session Law Service of New York, 1950 No. 1, p. 68.

17 Created by the 1948 Legislature by Chapter 675 of the Laws of 1948.

18 McKinney's Session Law Service of New York, 1950 No. 3, p. 232.

19 New York Times, New York Herald Tribune, March 23, 1950.

20 Chapter 250 of the Laws of 1950. Termination date of law is June 30, 1952. See Sec. 1, subd. 2. Subsequent citations of this statute will be referred to simply as: Law.

21 McKinney's Session Law Service of New York, 1950 No. 5, p. 595.

22 New York Times, March 22, 1950.

23 McKinney's Unconsolidated Laws Secs. 8581-8594, Chapter 274 of Laws of 1946 as amended by Chapter 704 of Laws of 1947, Chapter 678 of Laws of 1948, Chapter 591 of Laws of 1949.

24 See *supra* note 23 at Sec. 11, Subd. 1—"The establishment of a rent control area and the establishment of maximum rents therein and of regulations and orders relating thereto shall not be or become operative so long as rent control established by the federal price administrator pursuant to the emergency price control act of 1942 as amended, or other duly authorized officer or agency of the United States pursuant to any federal law is in force and in effect. . . ."

though it was in effect for a comparatively short period during a lapse of federal controls in July, 1946,[25] there are no court decisions construing this "Emergency Housing Rent Control Law."

The present law follows the pattern of the "standby" legislation.[26] The Emergency Housing Rent Control Law[27] consists of 16 sections which have been augmented by regulations promulgated by the Temporary State Housing Rent Commission on May 1, 1950. The regulations are divided into 10 parts, 3 of which deal solely with general procedural matters of the commission.

Pursuant to the Housing and Rent Act of 1947 as amended,[28] and the Emergency Housing Rent Control Law,[29] the Governor notified the Federal Housing Expediter that the "state rent control law shall be in lieu of federal rent control within defense rental areas in this state" and that the state controls shall take effect on May 1, 1950.

The organizational set-up of the new law is as follows: The State Housing Law is directed by the State Rent Administrator.[30] Local Rent Administrators[31] are in charge of local rent offices, of which there are 16 throughout the state as of May 1, 1950.

Generally speaking, the same housing accommodations are subject to the state law[32a] as were covered by the predecessor Federal[32b] and City[33] laws. As far as hotels are concerned, the emphasis is shifted to the tenant.[34] If the tenant occupied a hotel housing accommodation continuously for 90 days prior to March 1, 1950, he is covered.[35] It should be noted that housing accommodations resulting from conversions completed on or after May 1, 1950, shall continue to be subject to rent control unless decontrolled, which shall be done if substantial structural change results in additional self-contained family units.[36] Housing accommodations already on the rental market may not be withdrawn without the written approval of the Administrator if a tenant must be evicted.[37]

The maximum rent for housing accommodations shall be the lower of rents prescribed on March 1, 1950, under federal or under city controls, except that where rents paid on that date do not include any adjustment granted by the Federal Act for new or additional services to which the tenant then in possession had agreed, either expressly or impliedly, the maximum rent shall be increased by the amount of such adjustment.[38] The Regulations also make provisions for housing accommodations for which no maximum rent was in effect on March 1, 1950,[39] and for changes in rooming house accomodations.[40]

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25 Public Law 108, 79th Congress, 1st Sess., effective to June 30, 1946 (59 Stat. 306); The Price Control Extension Act of 1946 (60 Stat. 664) not effective till July 25, 1946.

26 See note 22, *supra.*

27 See note 20, *supra,* Sec. 16 (short title).

28 See note 9, *supra,* at Sec. 204(J) (1).

29 Law, Sec. 11.

30 Joseph D. McGoldrick, appointed by Gov. Dewey on March 31, 1950. See State Rent and Eviction Regulations, Sec. 3, Subd. 1. Subsequent Citations will refer to these administrative rulings simply as : Regulations.

31 Regulations, Sec. 3, Subd. 2, 3.

32a *Id.,* at Sec. 9, 10.

32b *Supra,* note 9. See Geller and Geller, 1949 Housing and Rent Legislation 19 N.Y.C.P.A. 364 (June, 1949).

33 See notes 6, 7 and 8, *supra.*

34 Regulations, Sec. 3, Subd. 10.

35 *Id.,* at Sec. 3. Subd. 11.

36 *Id.,* at Sec. 11.

37 *Id.,* at Sec. 12; Law, Sec. 9, Subd. 4.

38 Law, Sec. 4, Subd. 1(a); Regulations, Sec. 21, Subd. 1.

39 Regulations, Sec. 21, Subd. 2, 3.

40 *Id.,* at Sec. 21, Subd. 4, 5.

Changes in maximum rents by the order of the Administrator shall be effective on the date that the order is issued,[41] thus eliminating the retroactive orders which caused such a furor under the O.H.E. regulations.[42] At this time the only ground for an increase in the maximum rent is an increase in dwelling space, essential services, furnishings or equipment.[43] If the change were made between March 1, 1950, and May 1, 1950, with the tenant's consent, the adjustment shall be the lesser of the rental value and the amount agreed to by the tenant.[44] If after May 1, 1950, the landlord and the tenant in actual occupancy have entered into a voluntary agreement for increase in services, etc., an increase may be granted, but not in excess of the rental value determined by the Administrator.[45] It should be noted the law requires the landlord to certify that he will maintain all services as of the maximum rent date in order to be entitled to any increases.[46]

As far as other increases in the maximum rents are concerned, the law provides[47] that not later than December 1, 1950, the Commission shall provide regulations for individual adjustments where there are:

1. Out-of-pocket losses due to substantial and unavoidable increases in property taxes or other operating expenses, not including allowances for depreciation, obsolescence or other reserves, and these items exceed rental income, or
2. Severe hardship will result because the maximum rents are substantially higher or lower than comparable rents, or
3. Gross inequities.

It is not until January 15, 1951, that the Commission is charged with preparing a rent control plan and regulations.[48] The plan should provide a system of controls which are fair and equitable and which will provide an orderly transition from and termination of emergency controls. The regulations are not to become effective until March 1, 1951, and if the legislature disapproves such rules by February 15, 1951, they shall be inoperative.

Under certain circumstances where there has been a decrease in services, dwelling space, furniture, furnishings or equipment, the Administrator may order a reduction in the maximum rent.[49]

The Commission has by regulation set up a system of registration for all housing accommodations except for those which have previously filed with the Federal Government.[50]

So long as the tenant continues to pay the rent to which the landlord is entitled, no tenant may be removed after May 1, 1950, from any controlled housing accommodation by an action to evict or to recover possession[51] unless authorized by a court of competent jurisdiction in compliance with the Rent and Eviction Regulations.[52]

The proceedings for eviction are divided into two major sections, depending upon whether or not a certificate of eviction is necessary.[53]

The Commission requires fair notice to be given to the tenant and the Local Rent Office[54] before commencement of court process in the following situa-

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41 *Id.*, at Sec. 32; Law, Sec. 4, Subd. 4.
42 See note 5, *supra*.
43 Law, Sec. 4, Subd. 2(a).
44 *Ibid.;* Regulations, Sec. 33.
45 *Ibid.*
46 Law, Sec. 4, Subd. 2(b), 3.
47 *Id.*, at Sec. 4, Subd. 2(b).
48 *Id.*, at Sec. 4, Subd. 2(c).
49 Regulations, Secs. 34, 35; Law, Sec. 4, Subd. 3(b).
50 Regulations, Part IV.
51 Regulations, Sec. 51; Law, Sec. 12.
52 Regulations, Part V.
53 *Id.*, at Secs. 52, 53; Law, Sec. 12, Subd. 1(h).
54 *Ibid.*

tions, where an eviction certificate is not necessary:

1. The tenant continues to violate a substantial obligation of his tenancy after written notice by landlord.[55]

2. The tenant is committing a nuisance, which interferes substantially with the comfort or safety or other tenants, or the tenant has been found guilty by a criminal court of committing a nuisance.[56]

3. The tenant who is using a housing accommodation for immoral or illegal purposes has been found criminally guilty of such act.[57]

4. The tenant who has a written lease terminating on or after May 1, 1950, refuses upon demand of the landlord to execute a written extension or renewal thereof for a further term of like duration not in excess of one year but on the same terms and conditions as in the previous lease.[58]

5. The tenant has unreasonably refused the landlord access to the housing accommodation for the purpose of inspection or showing the accommodations to a person having a legitimate interest therein; provided, that the tenant's lease or other rental agreement does not bar such entry.[59]

Where a certificate of eviction is required, it should be noted that the landlord must wait three months from the time the certificate is issued before he can begin proceedings to remove the tenant, except that in certain circumstances a shorter period may be decreed.[60] The law[61] and the regulations[62] cite the following causes for eviction as requiring a certificate issued by the Administrator:

1. The landlord seeks in good faith to recover possession of housing acommodations because of immediate and compelling necessity for his own personal use and occupancy or for the use of his "immediate family." "Immediate family" is defined as son, daughter, father or mother. (Other provisions of the regulations cover co-operative housing, recent acquisitions, and tax-exempt organizations.)

2. No part of the accommodations are used by the tenant as his dwelling, the tenant's lease or rental agreement having terminated and the persons in possession are subtenants or other persons who occupy under a rental agreement with the tenant.

3. The landlord seeks to recover possession for the immediate purpose of substantially altering, remodeling or demolishing the housing accommodations, provided the landlord has secured such approval therefor as is required by law.

Although not specifically mentioned in the State Rent Law, the Regulations provide that no person, including landlords or tenants in occupancy, shall require a tenant or prospective tenant to purchase or agree to purchase furniture or other property as a condition of renting housing accommodations.[63]

Security deposits may not exceed one-month's rent for a controlled apartment, in addition to the normal collection of one-month's rent in advance, but in any case the security must have been permitted previously by either the Federal or City laws.[64]

A fine or not more than $5,000, and imprisonment for not more than 2 years may be the punishment for willful violation of the State Rent Law.[65]

If a landlord collects rent in excess of the maximum rent, within one year from the date of such violation the tenant paying such rent may bring an action against the landlord. If the tenant fails to act within 30 days from the date of the overcharge, the Commission may act on behalf of the state within such one-year period. If the state acts, the tenant is thereafter barred from bringing an action for the same violation.[66]

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55 Law, Sec. 12, Subd. 1(a); Regulations, Sec. 52, Subd. 1.
56 Law, Sec. 12, Subd. 1(b); Regulations, Sec. 52, Subd. 2.
57 Law, Sec. 12, Subd. 1(c); Regulations, Sec. 52, Subd. 3.
58 Law, Sec. 12, Subd. 1(d); Regulations, Sec. 52, Subd. 4.
59 Law, Sec. 12, Subd. 1(e); Regulations, Sec. 52, Subd. 5.
60 Regulations, Sec. 54, Subd. 2.
61 Law, Sec. 12, Subd. 1(f), (g), (h).
62 Regulations, Secs. 55, 56, 57, 58.
63 *Id.*, at Sec. 63.
64 *Id.*, at Sec. 65.
65 *Id.*, at Sec. 71; Law, Sec. 10, Subd. 2.
66 Law, Sec. 10, Subd. 5.

The right of judicial review granted in the new law[67] is an important factor to be borne in mind by the landlords and tenants of controlled accommodations.

It is apparent that under the 1950 State Rental Law, maximum rents, with relatively few exceptions, will remain "frozen" at least until December 1, 1950.

Those of you who have assisted in the preparation of forms for the various rent control organizations will be pleased to know that the Regulations issued by the Commission are very readable and that, according to the State Rent Administrator, the number of forms required for public use has been reduced by 80%.[68] However, there are many unsettled problems facing the new law and its administration. The constitutionality of the State Rent Law remains to be tested in the New York courts and some attorneys doubt its validity.[69] Some unsettled questions concern: Handling of Federal Office of Housing Expediter rent reductions after March 1, 1949,[70] possible decreases in rent based upon the comparability basis where voluntary 15% increases were given by some tenants[71] and elimination of rent reductions after restoration of reduced services such as painting.

The Business[72] and Commercial[73] Rent Controls of New York State have also been revised by the 1950 legislature, but the changes have not been so great.

These laws were first enacted in 1945, for the purpose of stabilizing rents at emergency levels which were 15% in excess of the rent paid on the so-called "freeze" date. In addition, a tenant may generally retain possession of his space after the expiration date of his lease by payment of "statutory" rent to the landlord.

The Commercial Act enacted on January 24, 1945,[74] controls lofts and wholesale establishments. This law established March 1, 1943, as the freeze date. The Business Act went into effect on March 28, 1945.[75] It added stores, offices and almost all other non-residential space to control and fixed June 1, 1944, as the freeze date. The statutes are virtually the same except for their coverage and the consequences of the different freeze dates.

These laws are limited to New York City, although Albany also has a separate law[76] covering its non-residential rental property.

The 1950 amendments to these laws have been sponsored by the Temporary State Commission to Study Rents and Rental Conditions. This Commission also sponsored the State Residential Rent Control Law and the Commission's actions in these non-residential rent control amendments may furnish some clues to possible future residential statutes and regulations.

The first change recognized the continued shortage of business and commercial space, despite some improvements in the situation. The Commission therefore recommended the extension of the statutes until July 1, 1951.[77]

All commercial[78] and business[79] space which become vacant after the effective

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67 *Id.,* at Sec. 8.

68 N. Y. Herald Tribune, May 1, 1950. The forms available at this time follow the pattern of the regulations; i. e., the number of the form and substance of application are identical with the substantive rules promulgated by the Temporary State Housing Rent Commission.

69 Fougner, State Rent Control, Real Estate Forum, May 1950, p. 4.

70 See note 69, *supra.*

71 N. Y. Herald Tribune, May 7, 1950.

72 Chapter 326 of the Laws of 1950, Unconsolidated Laws, Sec. 8521 *et seq.*

73 Chapter 327 of the Laws of 1950, Unconsolidated Laws, Sec. 8552 *et seq.*

74 Laws of 1945, Chapter 3.

75 *Id.,* at Chapter 314.

76 Laws of 1950, Chapter 114.

77 Laws of 1950, Chapter 326, Sec. 17, Chapter 327, Sec. 18.

78 Chapter 327 at Sec. 13.

79 Chapter 326 at Sec. 12.

date of the extended statutes will be decontrolled. In the Commission's report, it was stated that this provision did not violate the primary purpose of the emergency statutes, which is to guarantee to tenants continued occupancy during the emergency. When a tenant leaves voluntarily, the State's duty to that tenant should be ended.

A problem which arose during the previous year was the amount of rent to be paid by a sublessee after the main tenant vacates. Formerly, the rent paid by the subtenant to the main tenant for all or part of the space was declared to be emergency rent, although more often than not, that amount was substantially less than the rent of the main tenant. Under the 1950 amendment,[80] the landlord offers the subtenant or subtenants occupancy at the rent reserved or the emergency rent payable by the main tenant at the time he vacated. If such sublessee fails to execute such a lease for a period of one year, the landlord shall be entitled to remove him.

Where an owner or landlord repossesses space for his own use, he must within 30 days occupy said space and actively conduct his business therein for one year, or else he shall be liable to the dispossessed tenant for all damages on account of such removal.[81] Amendments to this section of the law now provide that if the making of alterations shall prevent the active conduct of business therein, the period of 30 days shall begin to run after the completion of such alterations.[82] Also, that where the landlord during such year shall permit the making of alterations within said space for a tenant who shall become entitled to possession after the termination of such period of one year, the liability for damages on account of dispossession shall not apply.[83] A lessee of a whole building for 21 years or more has also been given the same rights as an owner to recover possession in good faith for his own use.[84]

The tenant in possession can also be dispossessed by a new amendment where on or before January 24, 1945, the landlord in writing executed and delivered a lease of the entire building or other rental area for a term of not less than ten years and the tenant named in said lease has demanded in writing from the landlord possession of such building or rental area for his own and immediate use, under the terms of the lease.[85]

Section 4 of the Commercial and Business Laws provides for increases of rents in excess of the emergency rent to be fixed by arbitration or the Supreme Court. There are two basic, but different, types of computations to be made in the determination to fix a reasonable rent in excess of the emergency rent based upon the fair rental value of the tenant's space.

The first calculation, as illustrated in subdivision 1 of section 4, determines whether the landlord is receiving a reasonable rental on the fair value of his entire property. Any deficiency in the reasonable rental is then applied to various commercial and business spaces in the building giving due consideration to the amount and character of the space occupied by the tenants and to the relation of such rent to the gross rentals in the entire building.[86]

A net annual return of 8% on the fair value of the entire property including the land is now presumed to be a

80 Chapters 326 and 327 at Sec. 4, Subd. 4.
81 Chapters 326 and 327 at Sec. 8(d)(2).
82 *Ibid.*
83 *Ibid.*
84 *Ibid.*
85 Chapters 326 and 327 at Sec. 8(h)(5).
86 *Court Square Bldg., Inc.* v. *City of N. Y.*, 273 App. Div. 441, 77 N. Y. S. 2nd. 847 (1948), (Floors occupied by tenant 10% less valuable than top floors in office building); *Sibro Holdings* v. *Krapp*, 274 App. Div. 129, 79 N. Y. S. 2d. 805 (1948), (Flat increase of 25% of each tenant's rent fair division of deficiency); *Matter of Philger Realty Corp.*, N. Y. L. J., Jan. 31, 1950, p. 382, col. 6 (store and lofts in five story building each assigned a percentage of the total based on rental value of space).

reasonable return.[87] The prior formula provided for 6% on the fair value of the entire property including the land plus 2% of the principal for amortization of any mortgages thereon or in the alternative, 2% per annum for depreciation on the fair value of the improvement inclusive of the land.[88] The State Rent Commission in an attempt to put unencumbered property on the same basis as mortgaged holdings, inserted the depreciation calculation.[89] Basic accounting concepts and real estate principles have long held that land is not depreciable.[90] In addition, in one decision a Supreme Court Justice[91] pointed out the contradiction in terms in the wording of the clause itself; namely, improvements mean structures or buildings upon vacant land. Land not built upon is referred to as unimproved.

Although the statute reads that 8% shall be presumed to be a reasonable return, in several instances, the courts have refused to follow this presumption[92] and in varying cases have used 2% on land and 8% on building,[93] 4% of fair value and 2% on building,[94] 6% on land and 8% on building,[95] and 4% on fair value.[96]

In most of the cases where there is a variance from the presumed reasonable return, it is due to an inadequate improvement in comparison with the value of the land.[97]

The next problem concerns the valuation of the property. The statute creates another presumption as to value; that is, the assessed value of the entire property as shown by the latest completed assessment-roll of the City, shall be presumed to be the fair value of the premises, but other lawful evidence of the fair value may be offered and received.[98] The Supreme Court has had much experience with the valuation of real property for certiorari and condemnation proceedings. In the usual situation[99] the court gets a number of values: assessed valuation, landlord's expert, tenant's expert, certiorari value, and purchase price. In most cases the court's value is either the assessed value or somewhere below this value.[100]

To the fair return (determined by multiplying 8% or some other alternative percentage by the fair value) is added the cost of maintenance and operation of the entire property including amounts paid for taxes, but excluding

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87 Laws of 1950, Chapters 326 and 327, Section 4, Subd. 1.

88 Laws of 1949, Chapters 534 and 535, Sec. 4, Subd. 1.

89 Report of Temporary Commission to Study Rents and Rental Conditions, Legislative Documents (1949) No. 52.

90 Paton, Accountants' Handbook, (3rd. ed. 1947) p. 600; Finney, Principles of Accounting, Intermediate, (2nd. ed. 1942) p. 259.

91 *Autumn Corp.* v. *Lederman*, N. Y. L. J., Dec. 6, 1949, p. 1525, col. 7, Justice Hammer.

92 *Schack* v. *Handel*, 271 App. Div. 1, 62 N. Y. S. (2d) 407 (1946); *Appelby* v. *Walsh Paper Co.*, 88 N. Y. S. (2d) 203 (1949).

93 *Spitz* v. *Barsante*, N. Y. L. J., Jan. 11, 1950, p. 120.

94 *Cedar Temple Realty Corp.* v. *Astor*, 86 N. Y. S. (2d) 367 (1948), modified on appeal.

95 *Autumn Corp.* v. *Lederman*, *supra*, note 91.

96 *441 B'way, Inc.* v. *Dabakian*, N. Y. L. J., Jan. 19, 1948, p. 219, col. 7.

97 See *supra* notes 92 to 96, inclusive.

98 See *supra* note 87.

99 *Autumn Corp.* v. *Lederman*, *supra*, note 91, (assessed value $100,000, landlord's expert $105,000, tenant's expert $75,000; landlord's expert in certiorari proceeding $60,000); *Matter of Spring-Crosby-Lafayette Corp.*, N. Y. L. J., Jan. 30, 1950, p. 363, col. 4 (landlord's expert $300,000 for rent law and $126,500 for certiorari action, tenant's expert $125,000); *Schack* v. *Handel*, 271 App. Div. 1 (1946) (assessed value $515,000 reduced to $402,000 by certiorari, purchase price $325,000); *Schwinger* v. *Kramer*, N. Y. L. J., Dec. 27, 1949, p. 1777, col. 1 (landlord's expert $85,000, assessed value $40,000, tenant $50,000, purchase price $61,725 (1947)).

100 *Autumn Corp.* v. *Lederman*, *supra*, note 99 (court set value of $85,000); *Matter of Spring-Crosby-Lafayette Corp.*, *supra*, note 99 (court found value to be $150,000); *Schack* v. *Handel*, *supra*, note 99 ($400,000 fair value); *Schwinger* v. *Kramer*, *supra*, note 99 (fair value $65,000).

interest or amortization on any encumberances.[101] It should be borne in mind that the court makes its determination only upon the figures submitted by the various parties to the proceedings; it makes no independent examination, so that all pertinent information must be submitted in the proceedings. Items which should or should not be included in the cost of maintenance and operation vary depending upon the particular facts of each case, but certain generalizations may be made. Depreciation is not includible unless there actually has been some reduction in the value of the property.[102] Generally, all recurring reasonable out-of-pocket expenses are allowed.[103] The Courts try to allocate permanent improvements over their life.[104] In various cases the following items have been disallowed: ground rent paid by lessee,[105] total taxes paid where reduced by certiorari in prior years;[106] in one case the judge disallowed officers' salaries, franchise taxes, auditing, trustee's fees and legal expenses.[107]

If the total of the allowable expenses and the fair return amount to more than the present rentals, then the deficiency may be prorated among the various non-residential tenants based upon such factors as amount of space, location, etc. as outlined above.[108]

In 1948 the Court of Appeals held that if an owner is receiving the statutory overall return he cannot obtain an increase from one tenant whose rent is inadequately low.[109] For this reason there was added in 1949 a second or alternative computation. This was the "square foot" formula which was adopted to bring the rent of statutory tenants up to a standard of value in the entire building.[110]

Due to the form and phraseology of this subdivision, its construction by the courts resulted in rental awards not contemplated by the Temporary Commission to Study Rents and Rental Conditions when it recommended its adoption in 1949.[111]

Generally this "alternative" proceeding provided that the basic return (8% of the fair value) should be divided into the total net rentable space for the purpose of computing the fair rental value per square foot of the rentable space. The court could then increase the rent of any tenant paying less than this fair rental value, unless he occupied the premises under an unexpired lease or other agreement.[112]

Literal construction of the statute as thus amended in 1949 created two major problems. The first difficulty was the absence of any allowance for cost of maintenance and operation in the determination of the basic return.[113] This was corrected in 1950. The 1950

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101 Laws of 1950, Chapters 326 and 327, Sec. 4, Subd. 1(a).

102 *Matter of Fifth Madison Corp.*, 297 N. Y. 155 (1948); *Schack* v. *Handel*, see note 92, *supra*.

103 See note 102, *supra;* but see application of *Stabler*, 89 N. Y. S. (2d) 205 (1949) (Appellate Division rules that great weight should be given to definite increases or decreases of expenses in the period after the preceding year).

104 *Schack* v. *Handel*, see note 92, *supra; Joanette Jrs., Inc.* v. *Princeway R. Corp.*, 272 App. Div. 420 (1947).

105 *Matter of Dworman*, 270 App. Div., 568, 61 N. Y. S. (2d) 352; application of *Flushingside Realty and Construction Co.*, 67 N. Y. S. (2d) 155, 186 Misc. 117 (1946).

106 *Home Savings Bank of City of Albany* v. *Associates Discount Corp.*, 91 N. Y. S. (2d) 530 (1949); *Matter of Winter*, N. Y. L. J., Dec. 29, 1949, p. 1805, col. 7.

107 *In re Fifth Madison Corp.*, N. Y. L. J., April 1, 1949, p. 1177, col. 4.

108 See note 86, *supra*.

109 *Matter of Relmar Op. Co.*, 297 N. Y. 609 (1948).

110 Laws of 1949, Chapters 534 and 535, Sec. 4, Subd. 2.

111 McKinney's Session Law Service of New York, 1950, No. 5, p. 601.

112 See note 110, *supra*.

113 Liberal construction of this provision in Matter of *551 Fifth Ave., Inc.*, N. Y. L. J., Nov. 9, 1949, p. 1169 held that it was clearly implied in the amendment that these expenses were to be included in determining the fair rental. Likewise held in *Matter of Rutherford Estates*, N. Y. L. J., Jan. 30, 1950, p. 363, col. 4.

amendments state that the basic return in the alternative proceeding was to be determined as prescribed in subdivision 1 of section 4 relating to the computation for the entire building, thus making specific reference to the inclusion of the expenses in the calculation.[114]

The second and more serious problem involved in the wording of the 1949 alternative computation amendment concerned the omission of any recognition that the square foot rental value of space in a commercial building varied from floor to floor. Also, no indication was evident that in business space the rental value of stores differed and that offices were rentable at different rates.[115] To change this court construction, the Legislature amended the alternative subdivision of section 4 to read that in determining the fair rental value per square foot the character and location of such space should be taken into account.[116]

The Commission also believed that many of the increases granted by the Supreme Court were not authorized by the statute and to curtail litigation, the legislators inserted a clause into section 4, subdivision 2 which permits "the tenant and landlord at any stage of the proceeding to enter into a written stipulation that the fair rental value per square foot of the . . . space occupied by the tenant is the amount stated and consenting to have the court so determine. . . ."

Finally, the last important change in the 1950 Commercial and Business Rent Laws also affects the alternative proceeding to fix rents. It provides "that in no event shall the rent of a tenant be fixed in an amount in excess of 15% greater than the rent being paid by the tenant . . ., and provided further, that the rent of a tenant shall not be increased as provided in this subdivision more than a total of 15% in any period of twelve consecutive months."[117] This provision is the result of the Temporary State Commission's belief that a few landlords have taken unfair advantage of the 1949 relaxation in controls pertaining to the alternative remedy.[118]

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[114] See note 110, *supra.*

[115] In the following cases where strict construction was followed an arbitrary average was prescribed for every location, despite the hardship that resulted in some cases: *Matter of Barry Equity Corp'n (Marcia Hat Co., Inc.)* N. Y. L. J., Oct. 13, 1949, p. 820; *Matter of Winter*, N. Y. L. J., Dec. 29, 1949, p. 1805, col. 7; *Matter of 247 Corp'n (Goldstein)*, N. Y. L. J., Dec. 20, 1949, p. 1715, col. 3; *Matter of Rutherford Estates*, N. Y. L. J., Jan. 30, 1950, p. 363, col. 4; *In re Jewelry Center Co. (Joseph)*, N. Y. L. J., Feb. 20, 1950, p. 628, col. 1; *Hirsch* v. *Israel*, N. Y. L. J., Oct. 14, 1949, p. 840. But in some cases, the court held it had the power to consider the locations of the tenants involved: *In re Fifth Madison Corp'n. (J. B. Doblin, Inc.)*, N. Y. L. J., Oct. 5, 1949, p. 723; *Matter of Richfil Estates, Inc. (Varsity Bags, Inc.)* N. Y. L. J., Jan. 10, 1950, p. 104, col. 3, Appellate Division, First Department, reversed Supreme Court decision in *Matter of Barry Equity Corp'n. (Marcia Hat Co., Inc.)* N. Y. L. J., May 9, 1950, p. 1637, col. 1.

[116] Laws of 1950, Chapters 326 and 327, Sec. 4, Subd. 2.

[117] See note 101, *supra.*

[118] See note 111, *supra.*

Can a City Plan Its Financial Future?

By Richard A. Atkins

I hope that in some degree this discussion will serve to rekindle the interest of certified public accountants in municipal affairs. There is no group whose continued active interest in municipal finance would have more value.

Can a City Plan Its Financial Future? For an answer to this question we must consider a number of things: the purpose of financial planning, the nature of municipal finance, the methods and material of financial planning, and current problems which tend to impede or limit such planning.

Purpose of Financial Planning

The purpose of financial planning has been well stated by Dr. Frederick L. Bird, of Dun and Bradstreet. Dr. Bird has offered the thought that the "key principle of post-war local government finance should be the maintenance of a safe relationship between fiscal capacity and obligations undertaken." I like this thought. It carries a strong connotation of trusteeship. Any city which lives up to the principle of maintaining a safe relationship between its fiscal capacity and obligations is on sure ground.

Fiscal capacity is an elusive term. No precise measure of such capacity has been formulated. Cities with first-hand knowledge of the limits of their fiscal capacity are unfortunately those that have exceeded them. But some such guide must be sought. Otherwise financial planning has no point and financial calculations are only a gamble. An effort should be made to apply the principle just suggested. Then there will be a method of criticism for every tax proposal and a proximate basis for evaluating expenditures. Each increment of debt, costs, or taxes can be referred to a principle. Financial planning will have purpose and take on meaning.

Nature of Municipal Finance

A few observations about the general nature of municipal finance should help our inquiry. This will establish the material we have to work with and give some of you a contrast to private business. Obviously the most important thing about a city is its public character. It is a public corporation chartered by the state legislature. Its primary function, in theory, is to provide common services necessary in civilized existence.

A city is not merely an administrative district, but with the passage of time it has acquired the characteristics of both a local entity and an administrative agency of the state government. It enjoys a considerable measure of independent action— yet it is ultimately and also intimately bound by state law, and, in ways that no one could hope to fathom, by state administrative supervision.

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Accountability and Legal Limitation

Given the nature of city government, the main features of municipal finance are accountability and legal limitation. I use the word accountability both in the army sense of official and personal responsibilty and in the sense of the way in which a public officer is held accountable for his actions to some rule. These rules may take the form of provisions in the state constitution, in statute law, and in the ordinances and acts of local governing bodies. Such rules may also derive from the administrative regulations of higher authority. Thus the state comptroller is empowered, among a great many other things, to prescribe the classification of municipal accounts and to review the taxing power of New York cities.

Municipal accounting methods reflect this responsibility. The fundamental of municipal accounting is fund accounting. In governmental terminology a fund is defined as a "sum of money or other resources set aside for the purpose of carrying on specific activities or attaining certain objectives in accordance with special regulations, restrictions or limitations." Funds are therefore established to make certain that revenues will be raised and expended in accordance with the rules which are imposed upon a city and its finance officers. The primary object of municipal accounting is not to ascertain whether government is showing a profit or a loss but to see that all revenue due is being collected and that expenditures are made in accordance with legal or budgetary restrictions.

(1) *Expenditure Controls*—Financial planning must reckon with these various limitations. Many of them are inflexible. Amendment of the state constitution is a cumbersome matter. State laws, local charters, and even local ordinances are not easily changed. The purposes of municipal expenditure are generally defined by law and in numerous instances are narrowly so defined. Some municipal expenditures are mandated by law. Thus the Education Law of the State of New York prescribes teachers' salaries and declares that certain types of instruction are obligatory and that a full time day school shall be in session not less than 190 days each year. A reading of the Social Welfare Law will soon convince anyone that localities are completely committed to a sweeping program of public assistance, the only real variant in which is the occurrence of need on the part of local residents.

(2) *Revenue Restrictions*—Taxing power is a distinguishing characteristic of government, but the sources of municipal revenue are closely defined by state law. Often the legislature goes further and fixes maximum rates of local taxation. Real estate taxation is limited after a fashion by the state constitution. A city is not free to select objects of taxation beyond those enumerated in statute. Even the so-called permissive tax law permits very little actual exercise of revenue power. The number of taxes made available is small; maximum rates are specified; and to some extent the apportionment of the tax proceeds is mapped out in detail. Since V-J day the revenue restrictions on cities have caused a good deal of feeling among municipal officials. They do not like to eat the crumbs which fall from the table at the current feast of taxes.

(3) *Debt Limitations*—The debt-incurring power of cities is subject to both constitutional and statutory restrictions as well as to local charter requirements. A city can borrow only for designated public purposes. There is an overall limitation on the amount of its indebtedness. Recent changes in the law affect the character of municipal debt and its term. Cities cannot borrow on thirty-year bonds for pavements with a life of ten years. On certain types of borrowing New York municipalities must make a "down payment" from tax revenues —a device for enforcing partial pay-as-

you-go and discouraging loans for trifling objects. Limitations on local debt practice date back a hundred years, and each new restriction is born of a desire to prevent mismanagement or extravagance. Municipal debt and credit stand in marked contrast to federal debt, for they are subject to market conditions of supply and demand and to well-established criteria of acceptability. A city cannot manufacture its credit or force the sale of its securities.

(4) *Prudential Supervision*—Cities are also subject to a variety of prudential controls—two of which I have mentioned in connection with the duties of the state comptroller. Syracuse is subject to periodic post-audit by the state and to regular disclosure of its condition in the form of financial reports. The city charter contains many special safeguards with respect to the annual budget of the city, the use and disposition of surplus, and administrative compliance with the appropriation orders of the city council.

I have moved over these topics in haste simply to sketch the legal framework of municipal finance and to suggest the inherent limitations upon financial planning. This is not to say that a city cannot make choices. Municipal expenditures are the product of a multitude of local forces—the community standard of living, its social and economic make-up, the nature and pliability of its politics and the real or fancied needs of local residents. Nevertheless, in financial planning a city must observe the channel markers, and hold to a charted course.

Methods and Material of Financial Planning

Now we can turn to the methods and material of financial planning and consider the differences between planning and expediency. At the risk of being somewhat general and with no thought of being original, I should like to touch upon some of the things which citizens and taxpayers might reasonably expect of financial planning and policy.

Sound Budget Policies

For forty years the executive budget has been regarded as the corner-stone of financial planning. It was, in fact, a product of the pioneer efforts of governmental researchers and some of us, I fear, have never advanced very far beyond it in our thinking about government. Today the executive budget is taken for granted in all except the county and some local subdivisions. There is no need for arguing that a good budget program is the first essential of financial planning. I would go a step further and ask that it live up to definite standards. The city charter requires a balanced budget in the conventional sense of the word, and we do not have to worry for the moment that the philosophy of deficit financing will spread to impair the concept of balanced budgeting at the level of local government.

So it is not with the budget as such that we need concern ourselves. The problem is with the methods of its preparation and the use that is made of it. There is always room for progress in budget preparation and enforcement. It is not enough that the budget should represent a balanced program — it should represent a realistic program. All revenue should be fairly and fully estimated in relation to actual experience and the carefully reasoned outlook. Concealment of assets or calculated construction of election year surpluses should have no place in a municipal budget program. Likewise the inflation of expenditure requirements, the creation of hidden reserves, and other such devices are equally without merit. By the same token the deliberate underestimate of real requirements should be avoided. I have in mind a large city which for years neglected necessary items of equipment in order to protect its inflated payrolls through thick and thin.

There is a special sense in which a municipal budget should be in balance and that is in terms of the actual outcome of the year's operations. Our charter contains safeguards to assure budget stability and no doubt we owe the agreeable state of the city's current account to these wise provisions of law and to the extremely conservative practices observed by finance officers. The Syracuse charter endeavors to prevent the occurrence of operating deficits, or more exactly, to prevent their recurrence and pyramiding.

During the depression, cities learned some hard lessons. Loose financial planning, as well as genuine distress, led to make-shift expedients in municipal finance, characterized by deficiency borrowing, extended refunding operations, incurrence of floating debt, and similar evils of recent memory. Of late, law-makers, municipal officers, and taxpayers have shown an increasing favor for procedures which guarantee that municipal budgets will balance in fact as well as on paper. We can properly expect that the city budget should represent much more than columns of neatly arranged figures leading to an ostensibly balanced result. It should be in balance not by the measure of arithmetic correctness but by the acid test of the outcome of annual operations.

Furthermore, I think the budget should possess vitality. Sterile repetition of line items year after year, perfunctory preparation and casual city council scrutiny and endorsement are not healthy signs. Yet I fear this is the level to which budget administration has sunk in many cities. One of the hopeful developments in the field of municipal finance is the apparent effort to unite budget-making with management. Sizeable jurisdictions have discovered that they can afford a budget officer who has year around responsibility for budget enforcement and follow-up. It seems to me the possibilities in this area are limited only by the tact, resourcefulness, and energy of the man who fills the position. Ideally the budget officer would make it his business to see what makes the city departments tick. An aggressive and enterprising department head surely enjoys the advantage in direct proportion to the budget unit's haziness about his operation and real needs.

Some cities are endeavoring to tie in the management-planning function with the budget officer. Under executive leadership, there is certainly a place for activity of this kind—in reviewing departmental methods and organization and in carrying over the results of the work into the budget itself. With the best will in the world, the usual department head is too engrossed in his operation to engage in continuous organization planning.

Just at the moment there is a large amount of talk about the Hoover Commission's recommendation for a "performance" budget and the idea is creeping into discussions of local financial administration. The performance budget is supposed to package money requirements with work programs, rather than with mere objects of expenditure such as men, materials, and supplies. It is supposed to measure results, not the isolated means whereby results are achieved. It should open the way for administrative audit and cost analysis. There is nothing novel about the idea. A number of years ago I happened upon a budget of the city of Toledo, which came as close to the performance principle as any federal budget we are ever likely to see. I should hesitate to pass judgment on the applicability of this conception to municipal government, but that should not keep us from being attracted to anything which might give the city budget more actual content and meaning. In short, we may be going into a period of trial and earnest exploration of new budget methods. Maybe after all these years the executive budget is due for a new lease on life. Its central position in financial planning should make us hope so.

Planning for Public Improvements

A comparatively recent development in municipal practice is the public improvement budget. Stated simply, a capital budget is a special program for planning and financing public improvements such as land and buildings, pavements, sewerage, water extensions, and major equipment. These improvements usually represent a permanent addition to a city's physical plant. Under capital budget procedure they are programmed separately from the regular operating budget which provides for salaries, supplies, and other current expense.

It is customary to formulate a capital budget program to include anticipated requirements over a number of future years. The capital budget as actually adopted covers needs for one year at a time. However, the program looks forward and as one year's capital budget is adopted, the whole program is projected forward in tentative form for another year into the future. Thus, the improvement program is subject to annual revision.

A capital budget must, of course, specify the method of financing public improvements. It should be so geared to the regular operating budget of the city that expenditures for both currrent expense and capital outlays will comprise a consistent scheme safely within the city's capacity to pay and properly related to existing and foreseeable sources of revenue.

Advantages of planning for public improvements are obvious. A capital budget enables a city to screen various proposals for public improvements and eliminate those which are unnecessary. Likewise, it permits a city to relate different needs and strike a reasonable balance among all the competing demands that are invariably put forward by operating departments and by outside pressures. Capital budgeting involves questions of city planning and engineering as well as finance and therefore presents the municipality with a chance to consider each improvement in terms of the present development of the city and its future growth.

Improvement planning of this description imposes administrative and political responsibilities which the average municipal official is reluctant to assume. Nevertheless, its acceptance by a growing number of cities is evidence of its validity in practice as well as in theory. A capital budget fills the gap in customary procedure. It allows localities to deal with factors of physical property in the same way that they are accustomed to deal with out-of-pocket expense. It is not difficult for anyone in a position of political leadership to make promises, but it is extremely difficult to make binding commitments. It is no simple matter for a city to state its financial position over a forward period. Yet improvement planning depends on future commitments and forward financial planning.

Debt Management

There is a close link, naturally, between financial planning and debt management. During the war practically all cities were able to reduce their debt as a result of the halt in emergency demands and capital outlays. Syracuse went a good deal further than most of the municipalities of the state and it has been on a pay-as-you-go basis for over six years. Solid and substantial benefits have resulted.

The city of Syracuse no longer relies on borrowing expedients employed down until 1944 to improve its current position at a future cost to the taxpayer. Such emergency measures as welfare expense loans, refunding loans, and "debt equalization" borrowing have all gone into the discard. Municipal debt has been brought safely in line with community resources. Direct bonded debt of the city, where debt service charges are met directly by taxation, has been so sharply reduced that it amounts to little more than one

percent of taxable assessed valuations. The city's debt can be viewed not only as safely manageable but as conservative in comparison with experience elsewhere.

As a result of debt reduction, a much smaller proportion of budget expense is represented by interest costs and principal payments on the municipal debt, and a much larger proportion of the tax dollar is going for regular municipal activities such as fire, police, public works and schools—which are direct services to residents of the city. In 1938, interest and principal payments on the tax-supported debt of the city exceeded five million dollars. Now they are $1,250,000 annually. Within the next three years, barring new loans, debt service costs will fall to a negligible figure.

These are indisputable gains but it will require a great deal of foresight to preserve and consolidate them. As a working principle, all regularly recurring outlays in the future should be met from current tax revenue. Certainly there is no wisdom in borrowing to replace motor equipment, to do routine street work, to make normal utility extensions, or to finance ordinary construction which goes on from year to year. It is particularly unwise when a city such as Syracuse has reached the limits of its physical growth, and to all intents and purposes, is near the end of its population growth. Borrowing should be reserved for exceptional projects with a long life and for undertakings which are largely or wholly self-supporting.

Once debt has been brought under control, it should be kept there. New York State constitutional debt limitations strike me as being liberal, especially when separate debt limits for overlapping jurisdictions and various exemptions are taken into account. No one should be lulled into a sense of security merely because these so-called limitations exist. Each locality might better establish its own criteria of debt capacity. I should expect them to be much stricter. In Syracuse we have two extra safeguards of our own—a local law which requires the city to budget $2,000,000 from current tax revenue before term borrowing is permitted and a charter provision which requires a popular referendum on bond proposals. While these measures should put a brake on hasty action, they intensify in many ways the need for future planning. Also, while we are on the subject, a weather eye should be kept on the overlying county debt, which is no less a claim on the taxable resources of the community than are the direct obligations of the city itself.

Current Problems of Financial Planning

The methods of financial planning, as I have outlined them, consist of progressive budget administration, public improvement programming, and debt control policies. Such planning, however, must operate in an environment which is more than the product of day-to-day circumstances and pressures. Three things, at least, are necessary:

First: Adequate and accessible revenues—meaning diversified and dependable sources of local budgetary revenue.

Second: Local initiative, leadership, and support—meaning official responsibility for and public acceptance of the effort to achieve a sound municipal economy.

Third: Sensible intergovernmental relationships—meaning friendly laws, and rational tax and financial relationships with other agencies of government.

Maybe this sounds like a large order, perhaps too much for this world—but it is no more than many municipal officials are asking. My three-point program sounds like nothing so much as a set of resolutions drawn by a municipal association or a conference of mayors duly assembled and in a serious mood.

Adequate and Accessible Revenues

The municipal revenue structure is the outcome of adjusting new demands to the traditional property tax base. Its growth has been largely outside local hands—the product of a series of improvising actions by the state since the end of the First World War. No one knows whether it is adequate except by rule of thumb. It is certainly not diversified in the usual sense of the word. And there can be question, in the light of past experience, as to its dependability.

Aside from the property tax, Syracuse receives operating revenue from state aids for education and public health, the per capita distribution of shared taxes, and the local utilities tax. Per capita payments were substituted in 1946 for the separate distribution of state-collected income, business and liquor taxes under varying formulas and in fluctuating amounts. These payments possess the virtue of certainty—which is to their credit in view of the disastrously low level to which prior distributions sank. But they are static in character—and the basis on which they rest, a payment of $6.75 per capita in cities, has no permanent significance. It is merely the resultant of certain tax proceeds which happened to be available for distribution a few years ago.

Our experience in Syracuse with local tax supplements has its good side and bad. The permissive tax law was a helter-skelter proposition, although no one has been in a hurry to suggest anything better. Its application has resembled a case of growing pains in local democracy. Framing a local tax policy, where for once an element of choice was present, was a sudden change from long years of reliance upon the real estate tax and state hand-outs. However, a pattern has been established, and over the future we are likely to see more rather than less of an effort to extend local taxing power. It will require a lot of reasoned judgment to prevent this effort from creating tax chaos and adding to the hazards of business.

I think we shall also see more interest in the property tax and perhaps some departure from the rigid features which typify this levy. In the race for revenue, we can expect to hear about property tax "reform", which is a polite way tax experts have of suggesting that possibly some additional revenue should be wrung from real estate. Most of the controversy over local property taxation has turned on the issue of what cities should spend rather than upon any studied analysis of what tax the owners of various classes of real estate might reasonably be expected to pay and under what circumstances. I know of at least one city where the assessment of business and commercial properties was cynically regarded as the balancing item in the municipal budget. Valuations were rigged each year for just that purpose. Real estate taxpayers will continue to be wary in the face of the revenue appetite of large cities. Experience has taught them that even tax limitations can be evaded, and in its present form and as recently liberalized in New York State, tax limitation is a frail protection.

Thus the outlook for financial planning is clouded by revenue trends and prospects—as they relate to state policy, to the outlook for supplementary non-property tax revenues, and to the continuing uncertainties of the local property tax. Before the war, I was involved in a serious effort to construct a long-range improvement budget. In another case, here in Syracuse, I was an interested observer of such an effort. Both efforts fell down for opposing and yet similar reasons. In each instance there was an unwillingness to relate improvement needs to local revenues. The revenue problem of cities and the political liabilities which go with it are the number one obstacle to financial planning.

Local Initiative and Leadership

If a city is going to plan its financial future, there must be initiative and leadership. These must be present within the city administration and they must be strong enough not only to carry along the divergent elements within city hall but also to attract and muster public support, especially, I should hope, among the taxpayers. Many officials have come to the conclusion after bitter experience that the best way to get things done is to go ahead and do them without being held back by the cluttered views and conflicting ideas of citizen groups. So far as this attitude is a reflection on civil responsibility, we have ourselves to blame.

Within the municipal organization itself, financial planning requires a careful balance of interests. It is not the sole concern of the chief finance officers, or of the city planning commission, or of the school board, or of any other leading officials. All these people must work in harness. For that reason, I am continually perplexed by the current agitation for fiscal independence of the schools. I can appreciate that any public agency would like fiscal independence—but I cannot see how it will contribute to progress in municipal finance or help realize the basic principle which we have laid as the purpose and end of financial planning. It seems to me that financial planning can best be accomplished by unified administration of city finances and that each move to dissipate responsibility and decision will only create confusion.

Enlisting civic interest in municipal finance is still another problem. Some cities are trying to make headway in this direction. Real estate tax bills are accompanied by literature purporting to explain what happens to the tax dollar. The annual financial report appears with a bright cover and contains some summary charts. Perhaps the municipal budget is preceded by a message which actually says something. Where an improvement program is under consideration or in progress, the views of citizen groups can be solicited or such groups may participate in its development. Successful financial planning depends upon the extent to which a city is either free from extraneous pressures or able to withstand them. This, in turn, depends upon success in awakening and holding the public interest.

You will recall that I have defined financial planning rather narrowly by adopting Dr. Bird's text. I spoke of maintaining a safe relationship between fiscal capacity and obligations undertaken. Such a view of the purpose of financial planning puts an extra burden upon those who seek public support or exercise leadership. Cities whose financial plans have consisted of multi-million dollar bond programs to change the face of the municipality have rarely had trouble in exciting interest. Prudent and persistent efforts to achieve a sound municipal economy appear dull by comparison. And yet I submit, as between the two, the latter course calls for a higher level of local statesmanship.

Intergovernmental Relations

Prior to the first war, the financial relationship of the State of New York to its political subdivisions was of minor consequence. Ten years later, state aids and shared taxes amounted to $160 millions. By 1940 they rose to $270 millions; and now they total $500 millions. For a generation the fiscal relationship of the state and the localities has been the dominant interest in state finance, now overshadowing in dollar volume the organizational expense and other obligations of the state government itself. Nearly a quarter of the Syracuse budget is financed from state funds. The county disburses state welfare and highway grants which are fully as important to its annual budget. The scope and importance of these various state funds are not recognized by most people, but they are a subject

of vital interest to those who have a vested interest in their continuance and extension.

In 1936, the McAneny Commission offered the thought that state aids had a dubious value. It declared that their "chief danger arises from evils usually associated with the spending of other people's money. State aid implies that local units are left with an appreciable degree of administrative power. They spend the money; that vague reservoir of almost illimitable wealth, the 'state', supplies it. It is almost as if the 'state' were some foreign power, whose financial burden could be of interest to the citizens of the locality only to the extent that a possible stoppage in the flow was indicated."

This was a harsh verdict, and perhaps fully deserved. But where the critics of state aid have failed is in their inability to suggest a means of halting the centralization of tax resources in Albany and in their inability to offer a solution for the fact that technological change, living standards, and social sensibilities and services all operate without direct relation to the fiscal capacity of the localities of the state. Merely to condemn state hand-outs leads us nowhere.

From the standpoint of financial planning—which is our interest at the moment—state grants are both a hindrance and a help. They are a help as a local tax supplement in financing large-scale social programs and school expenditures. They are a hindrance insofar as they tend to undermine local decision and policy-making. Unavoidably they reflect policies and decisions which are removed from local control. I do not speak from experience, but it seems to me that local financial planning in the disposition of state funds involves about as much actual initiative as the employment of a legacy which is doled out under a watchful eye. It is not planning at all; it is simply spending somebody else's money. It does not involve any real local responsibility—it merely means filling out a form from Washington or forwarding a voucher to Albany.

State attitudes waver. They are like those of an indulgent parent. After the war there was a great burst of state generosity. Now it is being hinted that the state has gone too far—80 per cent welfare reimbursements, it appears, may be excessive, although at the time of their enactment, they were heralded as the salvation of local government. Current Albany interest in expanding local real estate taxing power and debt incurring authority can be taken as another sign that the state is trying to back away from further financial commitments to the localities.

When the Moore Commission submitted its final report in 1946, it advised the cities that they were at last free to plan their financial future. Hopes for postwar stability were shattered as soon as prices started skyward the same summer. Rational tax and financial relationships seem as remote as ever. Perhaps the next move will be to reopen the subject through still another official inquiry and see if there is any way of balancing the functions of government with financial resources and relating control and responsibility in state and municipal finance. Otherwise financial planning at the local level must make the best of the fact that in a considerable area, local decisions and plans count for very little.

Summary

Let us retrace our steps for a moment. We have defined the purpose of financial planning as the maintenance of a prudent relationship between fiscal resources and commitments. The methods of such planning are modern budget administration, improvement programming, and firm debt control. But to bring financial planning into effective action, more is required. The municipality must have adequate and accessible revenue. There must be executive leadership and initiative within the city government, and public acceptance of the aims and purposes of financial

planning. Finally intergovernmental tax and financial relationships must leave a wide area free for the exercise of local responsibility.

As to our original inquiry—can a city plan its finances—the answer is yes, along the lines and within the limitations we have discussed. That there is duty to plan goes without saying. If there is value in what I have said, I hope it resides in my brief reference to the materials and methods of planning and in my reference to the obstacles which face the municipal official. The first has to do principally with financial administration. We should applaud and uphold all serious efforts to make progress in such administration. Mayors and finance officers who are endeavoring to make progress in this area deserve support because they are working with subjects which lack glamor and superficial appeal.

Yet municipal finance must be related at all times to the pressures and interests which swirl around city hall, to the complexities of our governmental system, and to the rivalries for revenue. At present 61 percent of the 850 million dollar state budget is earmarked for local assistance. That single fact alone makes us hesitate before assuming that municipal finance operates in an airtight compartment and that what goes on in Albany belongs in another world. As public finance becomes more complicated, so do the fiscal interrelationships of government.

Being responsible citizens, therefore, we are bound not only to seek and support a high level of local financial administration but to bring ourselves to appreciate the circumstances which condition financial planning.

AN ADIRONDACK VIEW

YOU NEVER CAN TELL. Wish I knew all the answers in advance, that is, the right ones. At our house we like to feed the birds, outside the kitchen window, on the side toward the woods and the lake. It's fun to see them so close, to see the grackle's white eyes. But you never know who you are going to feed; perhaps a red-winged blackbird, or a rose-breasted grosbeak and his plainly clothed wife, or a sleek little nuthatch.

The other evening, after dark, we looked into the feeding station to see how the day's menu had been treated, and there was Mr. or Mrs. Coon taking a snooze. The other folks in the household were called to see the coon. While we watched—plunk! A flying squirrel landed, looked in, didn't like the looks of the coon, jumped off, and glided to a safer place. You never can tell what you are going to feed when you start to feed birds!

And you never can tell what you are going to find when you start an audit! It's an adventure, anything can happen. And it's the same when the up-staters gather at their annual conference-in-the-woods at Saranac Inn (this year from June 25-28). Howard Swartz takes some of us out for a sail and the wind is nil. Someone gets up in a conference session and propounds his latest brain-child; and disagreeing winds spring up from all over the place. Walter Beach goes to bed early, gets out at 5 a.m., and has fresh trout for breakfast. The Buffalo contract bridge boys (Hamilton, Strong, and Hoch) ease the Saranac Lake member into buying the cards—and then, well, you guess who collects from the other three at the end of the session.

No, you never can tell what will happen upstate at Saranac Inn. Ideas you never thought of before jump into being; the Society's officers turn out to be real and regular guys; the CPA from Painted Post has a good idea and gets up in meeting to tell about it. Sometimes it even snows!

LEONARD HOUGHTON, CPA
of the Adirondack "Chapter".

Contemporary Practices in Costing Inventories

By Walter B. McFarland

Inventory costing is a perennial subject to which accountants have devoted many hours of discussion at professional meetings such as this. Doubtless you are all familiar with the American Institute of Accountants' Accounting Research Bulletin No. 29, which states that "The primary basis for accounting for inventories is cost." However, surprisingly little has been said or written on the question of what is included in or excluded from cost for inventory purposes. Perhaps accountants have been so largely preoccupied with assumptions as to the flow of cost factors (i.e., whether to use Fifo, Lifo, etc., in tracing the flow of material costs) that they have neglected the other aspects of determining inventory cost. Or, possibly the independent auditor just doesn't get much beyond direct material and direct labor in his investigation of what goes into his client's inventory.

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This paper was presented by Dr. McFarland at a technical meeting of the Society sponsored by the Committee on Cost Accounting & Inventory Methods, held on April 26, 1950, at the Engineering Societies' Building in New York City.

In discussion of the statement which I have quoted from Accounting Research Bulletin No. 29, the American Institute's Committee on Accounting Procedure has remarked that "Although princples for the determination of inventory costs may be easily stated, their application, particularly to such inventory items as work in process and finished goods, is difficult because of the variety of problems encountered in the allocation of costs and charges." My remarks will be directed toward some of these difficulties. However, I shall be concerned with costing inventories rather than with pricing inventories, for I shall omit from consideration all questions raised by changing market values.

Objectives in Costing Inventories

Before going further, it seems desirable to restate briefly the objectives which underlie accounting for inventories in order to make sure that we are all thinking in the same channel. The major purpose is determination of periodic income by matching costs against revenues. In this process, costs are classified into two groups, (1) those which follow the product through inventories and (2) those which are applied directly against the income of the period without assignment to inventories. In speaking of these two classes of costs, I shall use the now commonly accepted terms, *product costs,* and *period costs.* From the income statement point of view, the problem of distinguishing between product and period costs is essentially one of timing the charges against revenue. Product costs are charged against revenue at the time the merchandise is delivered, while period costs are charged against revenue

at the time the costs are incurred. The inventories serve as a reservoir in which certain costs are carried forward to be matched against revenues of a future period.

Costs Included in Inventories

Costs are not inherently product or period costs, but are classified as such for accounting purposes. In this respect the costing of inventories is largely a convention which we might expect to find expressed in the form of accepted accounting practice. If asked "which costs are included in inventories and which costs are charged against inventories without passing through the inventory accounts?" most accountants would probably reply that "All production costs are charged to inventories and all selling and administrative costs are charged to profit and loss."

A little over two years ago, the N.A.C.A. Committee on Research published conclusions drawn from a study undertaken for the purpose of determining from actual practice the types of costs which companies include in inventories*.

In this study we attempted to determine where the dividing line between manufacturing and non-manufacturing costs lies. For this purpose, information about practice in classifying costs of a group of borderline activities was obtained. This study disclosed a surprising range of variation in the treatment accorded specific cost items.

Since I have mentioned the fact that this material is drawn from an N.A.C.A. research study, it may be of interest to you to know how these studies are carried on before I proceed further. The research activities of N.A.C.A. are guided by a committee of thirty members of the Association. This committee initiates projects for study and supplies guidance. However, the collection of information, drafting of reports, and other detailed work is done by a salaried staff which is part of the Association's headquarters organization of which I am a member. In accord with our usual practice, we began the study of costs included in inventories with field interviews to learn how companies in a selected group classify their costs and something of the reasons which have led each company to adopt the accounting methods it uses. These interviews were supplemented by a mail questionnaire so that conclusions were based upon practices of 150 companies in total. In accordance with a policy of the Association, its research reports are not presented as authoritative statements of principle or procedure. In its research work, N.A.C.A. has followed the view that progress in industrial accounting will be most rapid if each accountant is unhampered by rules which might limit his exercise of initiative in making the best use of accounting techniques for his own purposes.

Classification of Borderline Items

Packaging may be the final operation in the manufacturing process, or it may take place at the time of shipment. In the first instance, the package or shipping container forms an integral part of the finished unit which is transferred to the finished goods warehouse. Thus, breakfast cereal is first put in packages and then into shipping cartons. Washing machines are crated before they leave the production line. All of the companies covered in our study classified the costs of such operations as manufacturing costs and applied them to inventory along with other manufacturing costs. On the other hand, when goods are packaged at the time of shipment, there is no such uniformity in the classification of costs. In the group of companies which reported packaging operations performed at time of shipment, approximately half treated costs of such operations as manufacturing costs applied to inventories and the other half treated these costs as dis-

* See "Costs Included in Inventories," Research Series No. 10, *N.A.C.A. Bulletin*, August 15, 1947.

tribution costs not chargeable to inventories.

The storage of finished goods is an operation that falls between the production of the goods and the distribution of them. When the goods awaiting sale are stored at the factory, the study showed a nearly even division of practice in classifying warehousing costs as a product cost or as a period cost. Companies charging factory warehousing costs to product inventories generally hold the view that warehousing is a part of the manufacturing process and that inventory costs should be accumulated up to the time of shipment. Companies reporting warehousing costs at the factory as a period charge follow the opposite point of view, that is, that the manufacturing process is completed when the product comes to rest in the warehouse and subsequent costs should be classified as distribution costs.

This division of opinion probably arises from the differing reasons for storing finished goods. In those cases where it is company policy to manufacture for inventory in order to attain an even rate of production and its consequent advantages of lower costs, the costs of storing finished goods can logically be viewed as costs of manufacturing. On the other hand, when stocks of finished goods are carried to aid the sales department in making prompt delivéries, storage costs can be viewed as distribution costs.

The study also covered a number of other costs, among which were costs of shipping finished goods, expenditures for research and development, and costs of operating various service departments such as accounting, purchasing, timekeeping, payroll, and personnel. Time does not permit me to describe our findings in detail, but again the most striking aspect of the replies was the diversity in classification of such costs.

While the statistics which bring out this diversity in cost classification practice are interesting, it is even more interesting to examine the reasons which underlie practice. In a number of instances it was apparent that classification of the costs was determined by placement of responsibility for cost control. Thus where cost accounting, purchasing, personnel, payroll, and similar functions are carried on by departments located at the factory and under authority of the factory manager, costs of operating these departments are classified as manufacturing costs. On the other hand, location of these departments away from the factory usually brings them under jurisdiction of executives concerned with general administrative or selling functions and the costs are placed in the non-manufacturing category.

Hence, it seems that cost classifications developed primarily for purposes of fixing responsibility for cost control also govern inventory costing practice in many cases. Since plans of internal organization differ widely from company to company, cost classifications which are based upon areas of managerial responsibility for costs produce results which are equally varied. Consistency in use of a chosen scheme of classification yields inventory figures which are comparable from year to year for a given company, but comparisons between companies may be impossible.

Administrative Salaries

In addition to the above borderline items, the study to which I have referred brought out some interesting aspects of practice in the classification of administrative salaries. Companies participating in the study were asked to tell how they classify salaries of corporate officers and executives above the rank of factory superintendent. Replies to this question first brought out the fact that many of these top executives are concerned wholly or largely with manufacturing activities and hence salaries of these individuals are usually (but not always) treated as manufacturing costs applicable to inventories.

In addition, there were found to be some companies which include in costs

entering inventories part or all of the salaries of executives such as president, general manager, corporate secretary, treasurer, and controller. These companies appear to follow the view that general administration and financial costs should be divided between product and period costs on the theory that manufacturing and distribution are the primary functions and that administration and finance are service functions. These companies are in the minority, however, and it seems that the boundary line between product and period costs is most commonly determined by the possibility of associating an executive's activities with manufacturing in some direct manner.

Exclusion of Fixed Costs from Inventories

Some years ago a writer in the N.A.C.A. Bulletin proposed that all fixed factory overhead be excluded from inventories.[1] Under this method, only those costs which vary with production volume would be inventoried. I mention this because there seems to be a surprising amount of interest in the idea today and a number of companies are experimenting with it. This indicates that we may hear more about this method in the future.

Classification of Unabsorbed Costs

Thus far I have dealt with costs which are classified at their origin as either product costs or period costs. Those companies which use predetermined burden rates or standard costs for costing production also have unabsorbed cost balances in the form of variances which must be disposed of in some manner. Are these variances product costs, to be divided at the end of the period between inventories and cost of goods sold, or are they period costs to be charged in their entirety against income of the period in which they arise? For my answer to this question I shall draw upon another N.A.C.A. research study in which we studied 72 standard cost systems in operation.[2]

Companies which use standard costs commonly incorporate them into the accounts because to do so both strengthens the effectiveness with which standards can be used for managerial purposes and facilitates the processes of accounting for costs. By use of standard costs, bookkeeping can be simplified and reports prepared more promptly. These advantages result from eliminating the need for carrying many variations in actual costs through the inventory accounts. When standard costs are used in accounting for costs, fluctuations in actual cost are diverted to variance accounts, accumulated there, and disposed of in total instead of being spread over numerous processes or orders.

The accountant in public practice who is called upon to help his clients in improving accounting for costs would do well to be thoroughly acquainted with standard costs. Frequently a standard cost system offers the least expensive way to get adequate costs for financial reports and additional benefits in the way of better information for cost control and pricing can often be had at little or no extra expense.

Accounting for Inventories Under Standard Costs

In determining income, the cost assigned to raw material, goods in process, and finished goods inventories is of prime importance. There exists a divergence of opinion as to whether or not standard costs are proper costs for this purpose. In the study which I have referred to, we concluded that the answer is not definitely yes or no, but

[1] Jonathan N. Harris, "What Did We Earn Last Month", *N.A.C.A. Bulletin*, Jan. 15, 1936. For an application, see Cecil E. Clark, "Fixed Charges in Inventories," *N.A.C.A. Bulletin*, April 15, 1947.

[2] For a summary of this study see Walter B. McFarland, "How Standard Costs Are Being Used Today for Control, Budgeting, Pricing: A Survey." *Journal of Accountancy*, February, 1950.

depends upon the standards employed and the success which the company has in keeping costs in line with standards. When the auditor finds that variance balances of significant amount appear on the books, it seems that he should investigate both the standards which have been in use and the company's cost control practices, for he must know something about both of these factors if he wishes to understand the significance of the variances. Since this is a long story, I can mention only a few of the points which were developed in our study and refer you to the published reports for a fuller explanation.

Treatment of Price Variances

Prices paid for materials, labor, and services are ordinarily determined largely by influences beyond control of company management. Hence most companies use price standards which are intended to reflect prices the company actually expects to pay rather than desired or "efficient" prices. Where the forecast of prices has been quite inaccurate and large variances have accumulated, these variances probably need to be divided between inventories and cost of sales, but most companies write off small variances. Another approach to the problem is to revise the price standards whenever prices change, but this nullifies the clerical savings from use of standard prices. The study which I have cited showed that annual revision of price standards was the commonest method among the companies interviewed.

On the other hand, a few companies use fixed price standards—i.e., standard prices which are not revised. Fixed standards cannot be used to cost inventories, but they do serve as bases for computing ratios with which to determine actual costs of inventories. In the study which we made, this plan of accounting was employed by several companies using a limited number of raw materials which fluctuate widely in price. For example, it was applied to inventories of lead by a manufacturer of storage batteries, to metal inventories by a manufacturer of silverware, and to certain major materials used by a chemical company. When applied to numerous items, the method becomes cumbersome and errors due to averaging may be important.

Performance Standards

Standards for material usage and labor performance are usually developed primarily for the purpose of aiding management in cost control. Most users of standard costs now agree that cost control standards should be set to represent attainable good performance. The N.A.C.A. study to which I have referred previously showed that almost all of the 72 companies follow this view, although some had not achieved it in practice.

In setting standards for these elements of cost, current control considerations are usually stressed more than the inventory costing considerations which are involved. However, there seems to be no reason why good cost control standards cannot be used for costing inventories. Where standards are good and cost control is effective, the net variance balances are usually relatively small and the difference between actual cost and standard cost is insignificant. In our study we found that only where standards were out of date or for some other reason did not reflect attainable costs were inventories adjusted by adding back some portion of the variances.

A point deserving emphasis is the fact that cost control standards must be kept up to date if they are not to lose their effectiveness. In many companies revisions are being made almost constantly to reflect changes in products and methods of manufacturing. Such changes affect material specifications, operation time standards and other details. To carry these changes through to preparation of revised product cost sheets requires a great deal of clerical

labor where changes in standards are frequent and many products are involved. For this reason current changes are usually made only in the detailed operation standards and are not carried all the way through to the standard cost of the finished product until the end of the year when a complete revision of standard costs is made. When this method is followed, a variance arises because the standard cost at which goods are charged into work in process differs from the standard cost at which they are credited to work in process. When a revised product cost standard is established at the end of the year, a physical inventory is taken and inventories are restated at this revised standard cost with the contra side of this adjusting entry being carried to the variance account.

Overhead Standards

Predetermined overhead rates which were essentially standard costs were employed in costing inventories for a number of years before standard costs for direct material and direct labor came into use. Where substantial fluctuations in annual volume of production occur it seems necessary to use standard or normal rates to avoid excessive increases in unit cost in periods of low volume. For example, one company bases its overhead rates used for inventory costing and for pricing on an average volume which takes into consideration plant capacity and market potential over a period of years. This company's unit costs reflect changes in wage rates, material prices, and operating efficiency from year to year, but costs are not affected by short term fluctuations in volume. Our study of 72 companies showed majority acceptance of this view that unabsorbed overhead is not an additional cost of the goods produced.

Standard Costs—Summary

When good standard costs are combined with good managerial control over costs, variances from causes controllable by management are usually not significantly large. In this case standard cost and actual cost of inventories practically coincide. Variances due to avoidable waste and inefficiency or to inadequate volume are generally charged off in the period in which they occur rather than carried forward in inventories. On the other hand, materially large price variances and over-absorbed volume variances usually call for adjustment of inventories to approximate actual cost. Where standard costs are not current and attainable they are likely to be unsuitable for costing inventories.

What Is Cost of Goods Sold?

The foregoing comments have dealt with cost of the goods remaining on hand at the close of an accounting period. However, I would like to raise another question which concerns cost of the goods which have been sold. The reader of accounting textbooks gains the impression that the figure appearing opposite the caption "Cost of Goods Sold" in the income statement, represents expirations of inventory values occasioned by sales of goods to customers. Probably most users of financial statements have this impression.

In actuality, cost of goods sold may include a variety of costs not admitted to inventories. These include unabsorbed costs such as variances, write downs to lower of cost or market, and sometimes other costs which may or may not have any relationship to cost of manufacturing the goods which were sold.

It should be noted that use of cost of sales as a catch-all account in which to absorb these adjustments can cause the gross profit to fluctuate in a manner not connected with either sales or production costs. Measures of performance based upon cost of sales or gross profit figures are likely to be vitiated. Inventory turnover ratios, comparisons between periods and between different units of the company etc., are thus affected.

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Marginal Costing

By Adolph Matz

Fixed-Variable Expense Analysis

The classification of expenses varies according to the nature of the expense and the purpose for which it is to be classified. The increasing importance of costs, and therewith cost accounting procedures, has pointed to the need for classifying expenses according to their fixed and variable nature. A third category, the semi-variable expense, is further analyzed in order to determine the fixed and variable components of the expense. Scatter charts or straight line equations assist in this task. The importance of the fixed-variable cost classification is emphasized in any consideration of the topic Break-Even Point. Break-even analysis and computation center about the fixed expenses. One of the formulas available[1] for computing the Break-Even Point is:

$$\text{B. E. Sales} = \frac{\text{Fixed Expenses}}{1 - \dfrac{\text{Variable Expenses}}{\text{Total Sales}}}$$

In break-even computation, fixed expenses play a major part.

Fixed-variable analysis is also of importance with respect to differential or marginal costs. The word marginal is introduced together with the word differential. In the cost accountant's terminology, the word differential is more common than marginal. Economists use marginal; engineers even use the term incremental costs. The three terms may be found used interchangeably in accounting publications.

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Differential Costs

Differential cost or marginal cost is defined as the additional cost necessary to produce one more unit of the product. One unit, of course, is merely a matter of speech. Expressed in that form it means n + one. In order to determine the differential cost, the flexible budget has become an excellent means of measuring the additional cost. In the N.A.C.A. Bulletin of December, 1949, an article by John L. Fox points out that the flexible budget can give the additional cost by extending the so-called normal capacity at which the company is working, in step-like increases from 80% to 85%, or 90%, or 100%. The additional cost would be the differential cost of manufacturing the new units. The new cost is not averaged out with the old cost. The article gives several very interesting illustrations pointing out how the flexible budget helps to determine the dif-

[1] See *"Cost Accountants' Handbook"*, Theodore Lang, Editor, The Ronald Press Co., New York, 1944, p. 105.

ferential cost and to aid in many managerial decisions.

The differential cost is the cost of the additional unit. The additional unit cost deals primarily with the variable or out-of-pocket cost. It tells what it costs to make one, or ten, or a hundred, or a thousand additional units. The fixed expenses, however, are considered to be recovered in the normal or regular capacity of the flexible budget.

Marginal Costing

This discussion is not meant to deal with the marginal or differential cost, however. The subject is "Marginal Costing." The ending "i-n-g" is significant. Marginal costing is a costing method. Cost accounting procedures make use of two costing methods: actual costing and standard costing, which are applied either to job order cost or process cost procedures. Marginal costing is another costing method which lends itself either to the job order or the process cost method. As a matter of fact, it supersedes standard costing, and is higher on the scale of costing method. It differentiates between variable expenses and fixed expenses. The cost of a job or process comprises only the variable expenses incurred and seeks to exclude any charge for fixed expenses.

Conventional Costing Procedure

Four basic steps are recommended for successful costing: the creation of an organization chart, the setting-up of a chart of accounts, the departmentalization of shop and office, and the analysis of fixed and variable expenses. The organization chart indicates the persons in charge of the departments so that responsibility can be placed as the costs are incurred and directed to the proper accounts by means of the chart of accounts. The departmental or functional cost control rests with the foreman or department head who is responsible for his direct (or variable) costs only. Fixed expenses enter neither the computation nor the report sent to the foreman.

Fixed expenses are not only the commonly known charges, such as depreciation, obsolescence, taxes, and interest on investment, but all those items which, by the company's own planning and budgeting, become fixed by policy They include all of the expenses necessary to be ready to produce. To find that fixed quantity, the quantity necessary for going ahead, is not an easy problem. But because it is such a problem, in business anyway, various schemes such as an average costing rate, or a normal capacity rate, or a capacity rate based on sales, or a capacity rate based on ability to produce, or a combination of the two, are set up with the hope that over the year or years all expenses will have been absorbed. Yet, while the full absorption might be possible over a cycle of years, the cost accountant is asked to prepare monthly statements of income and expenses in which the absorption process has not yet been completed, due to the fact that sales figures and production costs fluctuate quite seriously when shorter periods of time are considered.

Confronted with this situation, the cost accountant gives management a statement which shows the favorite expression, over-or-under-absorbed burden. When this term is brought into play, management is confused, because it cannot understand why, with sales up, profit is down, or with sales down, profit is up. The cost accountant's explanation is that everything is due to over-or-under-absorbed burden.

In cost thinking the terms total cost or average cost are widely accepted and used in cost computations. Under modern conditions of business, the concept of average cost has lost its mastery. Average cost looks at the entire production. The new look of cost accounting looks at spheres of production instead of the total. Total costs are not direct cost plus fixed expenses. That is a misconception of fixed expenses. Total costs attempt to average out all expenses when determining the cost of a product. It is this fault which marginal costing wants to overcome.

The Objective of Marginal Costing

Marginal costs consider only direct material, direct labor, and the variable costs caused by the manufacture of the unit. Because of this classification, marginal costing has also been named direct costing. This term places the emphasis upon variable costs which are identified as direct costs. A previous remark emphasized the fixed expenses. For that reason marginal costing could also be called "the significance of fixed expenses." This terminology indicates that it is neither the fixed nor the variable expenses that play an important part, but fixed and variable expenses in their spheres that must receive the attention of the accountant. The direct (variable or marginal) cost is a constant ratio. The fixed expenses, on the other hand, are a constant quantity.

The Burden Rate in Standard Cost Accounting Procedure

When a burden rate is created, and this is particularly true with regard to standard cost accounting procedure, the concept of normal capacity is all-important. Immediately the question arises, what is normal? All accounting, economic, or financial literature, shows several explanations with regard to normal capacity. But whatever concept is accepted, it will be no more than a method by which fixed expenses are absorbed over a certain period of time. The burden rate is a composite rate, consisting of a rate for fixed expenses and a rate for variable expenses. As a perfect harmonization of capacity, fixed expenses, and activity can seldom be expected, standard cost accounting procedure attempts to establish some means of judging that amount of burden which is not absorbed, calling it the volume variance. The volume variance in standard costs should consist only of fixed expenses which were not absorbed in production.

Fixed and Variable Expenses in Marginal Costing

Marginal costing proposes to take fixed expenses in total and make no distribution or allocation whatsoever. From the point of view of cost accounting procedure, this means simplification. From a teacher's point of view, it means a less complicated job of teaching. The departmentalization of the factory into producing departments and service departments requires in orthodox costing some scheme for the distribution of the service departments' costs to the producing departments, or even to other service departments, bringing them eventually to the producing department. Through the producing department the overhead is charged to the product.

The idea today is that variable expenses are all important when it comes to the departments. Departmental cost is controlled by the department head. Fixed expenses are management's job. If the cost for a department is based on the variable expense, omitting all fixed costs, and putting every department on a budget, then a budget (or expenditure or controllable) variance is computed to show the difference between actual expenses incurred and the budget allowed on the basis of activity. If the foreman stays within his budget, then the standard costs will be correct, and the gross margin per product will not fluctuate too much. The gross margins of all the various products form a kind of pool out of which fixed expenses are met.

The Contribution Plan

The above procedure was advanced years ago in department store accounting under the significant title "The Contribution Plan." Two types of expense classification exist: "escapable" and "inescapable." Escapable expenses are variable expenses. If the department does not exist, the expenses do not exist. Inescapable expenses are fixed expenses, such as administration, general offices, depreciation, taxes, insurance, etc. The department head, the buyer in a department store, controls the escapable costs, and no other allocation is made. The contribution plan in department store accounting was de-

vised about sixteen years ago because of the apparently misleading distribution methods of fixed expenses.

Production Planning

The elimination of fixed expenses in burden rate computation and product costing still gives management the task of providing a profitable volume to fill or keep the existing capacity active. No cost allocation of fixed expenses, and only the control of variable expenses departmentally or functionally might seem easy. The next step is to take this fixed expense, or this capacity, and use it to the best of everyone's ability. This means to make and sell all the units possible. This is a tremendous job of production planning. A good example is a foundry where jobs come in and must be scheduled and apportioned to overcome good and bad times. Some kind of peg boards or other production planning means are needed in order to know at all times the amount of capacity available for the next job. The cost, of course, would be the variable costs to make that product. The gross profit rate would be much higher because all fixed expenses must still be met. The production problem is not minimized at all. As a matter of fact, it is a much more difficult job than ever before.

Inventory Pricing

Having decided on a marginal or direct costing procedure, the next problem is one of inventory pricing. By this method, the inventory would not include any fixed expenses. This might be contrary to A. I. A. Research Bulletin No. 29 on Inventory Pricing, which says that "it should also be recognized that the exclusion of all overheads from inventory does not constitute an accepted accounting procedure." [2] However, many firms do just that. They do not include fixed overhead in their inventory valuation. As a matter of fact, the exclusion of fixed expenses comes closer to that desirable "lower cost." The oil refinery industry, which based its inventory valuation on the cost of 1933, says today that its inventory valuation is really just that variable cost at a very low point, because no overhead was included when the valuation was set at that time. The question arises: "What about taxes? Will the Internal Revenue Bureau permit it?" The Internal Revenue Bureau has recently issued two opinions which seem to indicate that it is willing to move away from that item which Bulletin No. 29 still wants to recognize, namely, an inclusion of fixed overhead or any type of overhead. The Treasury seems to become more liberal as indicated by the two statements.[3]

If the possibility exists for omitting the fixed expenses from inventory, then it seems illogical to "sell overhead to inventory." The overhead included in the inventory is the overhead of this period. The next period has its own overhead again. If a greater volume of sales is followed by greater production, it might work out. But if it does not, new problems are heaped upon the present ones. So the idea is advanced to allocate no fixed expenses to the inventory.

This procedure is also often accepted in standard cost accounting methods with respect to the disposition of standard cost variances at the end of the fiscal period. If the standard cost of the product is considered to be the true cost, then the variances, particularly the unfavorable variances, become a part of this period's cost of the goods sold. However, some of the fixed cost still reaches the inventory as it is included in the burden rate.

Marginal Costing and the Market

An important problem in connection with marginal costing is its relationship to the market. Some time ago the man-

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[2] "Inventory Pricing", *Accounting Research Bulletin, No. 29,* July, 1947, p. 237, American Institute of Accountants, New York, N. Y.

[3] See *Taxation Reports*, dated Oct. 16, 1947, p. 133 and p. 162, issued by the Research Institute of America, New York, N. Y.

ager of a sales department expressed the opinion that the showing of a variable cost only as the product cost might mislead the sales people and cause the inevitable statement "Let's reduce the price." This could be avoided by not giving any cost figures to the sales force. In other words, management sets the price and gives no cost information to the sales manager. If questions should arise, then a budget or management committee would have to clear this matter up. Today the emphasis on sales revenue is being replaced by emphasis on the gross profit or margin. In distribution cost analysis, the salesman's results are judged not by the volume, but by the gross profit, because very often a salesman who secures a large volume does not necessarily bring to the business that gross profit return which is essential for the payment of fixed expenses. The gross margin per product or sales outlet is considered more indicative of the sales effort than sales revenue, which is losing its value as a yardstick for measuring the results obtained.

The Cost Accountant and Marginal Costing

The above remarks lead to the inevitable question: Who sets the price? And the answer might be: The market or competition or supply and demand. Does the cost of the product or the work of the cost accountant play any part in this basic task of business management? Is not accounting and cost accounting in particular considered to be a tool of management? Much is written about the accountant at management's table or the accountant coming of age. The salesman finds favor because he sells and his efforts can be evaluated; the production man produces the goods and therefore his work can be measured; but the accountant's work and efforts are still misjudged in many places of business. Is this the fault of the accountant? Does his work offer so little aid in conducting the affairs of an enterprise? This attitude might still be prevalent in many companies, but not in all of them.

Some time ago the front page of The New York Times carried a picture of a meeting of the U. S. Steel executives and the C. I. O. At the table among the executives of the U. S. Steel Corporation was a man who was described as being the "Assistant Controller." It was a significant picture. Wage agreements with their subsequent labor accounting procedures need the cost executives' advice and judgment. Wherever the accountant has rendered assistance in managerial decisions, his position and his standing have improved.

The point is that statements and analyses must be of value to management, and the most satisfactory way to accomplish this is through the marginal or direct costing method. The total cost approach does not provide the answer. Presenting figures which must be explained and re-explained and even apologized for are no aid to management and no credit to the accountant. The problems of additional products, of abandoning or continuing a department, additions or replacement of equipment, all are solvable by the marginal or direct costing method. As a matter of fact, when average costing is used and such problems must be answered, a "rescramble" of the present procedure takes place, leading eventually to the marginal costing method.

Pros and Cons of Marginal Costing

Among the advantages of marginal costing are: 1) *The fluctuating element of manufacturing costs is eliminated.* The problem of over-or-under-absorbed burden is gone—there is no such problem. This must be so, because the fixed overhead is not included at all.

2) *The controversy of normal cost is eliminated.* Only the variable cost decided upon by management, engineering, production planning and cost accounting, is necessary to make and cost the job. The rest of the facilities, plant or personnel-wise, is provided for

the job on an over-all basis without charging any job for it, yet with each job contributing its share to the payment of fixed expenses.

3) *The uncontrollable expense, the fixed expense,* (uncontrollable by the department head) *is eliminated in his budget.* He is only controlling the variable cost of the department.

4) *Greater use can be made of the standard cost accounting system.* With the elimination of the normal capacity problem, stricter attention can be given to variances due to price changes in material, labor and variable expenses.

5) *The monthly profit and loss statement is now of real value to management* as to the confusing element of over-or-under-absorbed overhead is eliminated.

6) *There is a greater return on the dollar spent for accounting personnel.* The value of the employees increases as more beneficial assistance is rendered to management with respect to alternative choices.

What are the disadvantages?

1) *There is a reduction in the working capital.* If working capital is defined as the difference between current assets and current liabilities, the apparent non-inclusion of certain values in the inventory figures will reduce the working capital.

2) *There is a problem in psychology,* namely, of selling to the sales staff the idea that low cost does not mean price slashing. If selling efforts are misdirected, the success of the company's business is jeopardized.

3) *Marginal costing procedure does not readily reveal the demands made by individual products upon the capital or other services whose costs are part of the total fixed expenses.*

Conclusion and Bibliography

The possibility and potentiality of marginal or direct costing is considerable. At this time the nation is still producing at a high rate of production. How much longer, one does not dare venture a guess, as many political-economic forces are at play which might force a show down. Yet, the time will come when one must account for every iota of margin on every product produced and sold in order to remain in business. Costing and costing procedures must aid in this future problem.

In conclusion, it is appropriate to present a list of the most outstanding sources with respect to this thought-provoking idea:

1. "What did we earn last month?" by J. N. Harris, *NACA Bulletin,* January 15, 1936.
2. "What is wrong with most profit and loss statements?", by Clem N. Kohl, *NACA Bulletin,* July 1, 1937.
3. "The case against administrative expenses in inventory", by J. N. Harris, *Journal of Accountancy,* July, 1946.
4. "Selling overhead to inventory", by Philip Kramer, *NACA Bulletin,* January 15, 1947.
5. "Fixed Charges in Inventory", by Cecil Clark, *NACA Bulletin,* April 15, 1947.
6. *"Marginal Costing",* by F. C. Lawrence and E. N. Humphreys, published by Macdonald and Evans, London, England, 1947.
7. "The Pros and Cons of Marginal Costing", by G. C. Stone, *The Cost Accountant,* January-February, 1948.
8. "Direct Costs as an Aid to Sales Management", by J. N. Harris, *The Controller,* October, 1948.
9. "Most Profitable Product Volume-Taking Account of Costs and Competition", by L. J. Doyle, *NACA Bulletin,* February 1, 1949.

A Note on New York State Unemployment Insurance Taxes

By Samuel S. Ress

Unused Contribution Rate Credits Not Refundable

The Appellate Division of the New York State Supreme Court rendered a decision denying an application for a cash refund of unused Contribution Rate Credits under the New York State Unemployment Insurance Law.*

The court ruled on a problem that has faced many accountants because of inability to absorb the full amount of New York State Unemployment Tax Credit assigned to many firms during the past two years. These firms had suffered a large drop in payrolls. Clients felt that they should receive a cash refund from the New York State Unemployment Insurance Fund to cover the unabsorbed tax credit. These tax credits resulted from the large surplus paid into the fund during the war and the years thereafter. Now, when they needed the tax savings, they could not use them.

Some firms had gone so far as to apply the unabsorbed New York State Tax Credit for the period ending September 30, 1949, against liabilities for the fourth quarter of 1949 and the first quarter of 1950, because no tax credits have been issued for the current fiscal year by the New York State Unemployment Insurance Fund.

Justice Hefferman's opinion, concurred in by the entire court, in the *Matter of the Application of . . . Breslee Mfg. Co.* for a cash refund of unused contribution rate credits under the Unemployment Insurance Law against *Edward Corsi, as Industrial Commissioner,* stated:

> "This is an appeal by an employer from a decision of the Unemployment Insurance Appeal Board, which affirmed the decision of an employment insurance referee sustaining determinations of the Industrial Commissioner denying its applications for refunds aggregating $14,658.53, representing unused contribution rate credits issued to it for the years 1945, 1946 and 1947 pursuant to Section 577 of the Unemployment Insurance Law.
>
> "The question presented is one of first impression. No issue of fact is involved. The sole issue is whether appellant is entitled to a cash refund of unused contribution rate credits issued to it for the years in question.
>
> "Appellant had been engaged in business and subject to the payment of unemployment insurance contributions from 1943 to 1947. In 1946 it began to liquidate its affairs and by the end of 1947 it had discontinued business.
>
> "A contribution rate credit was issued to appellant for the year 1945 in the amount of $11,749.12. Of this credit $10,194.09 was used in payment of contributions payable for the four calendar quarters beginning with the third quarter of 1945. The balance of $1,555.03 was never used.

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Dr. Ress, who has written a number of articles which have appeared in *The New York Certified Public Accountant*, is a member of the Society's Committee on Clothing Manufacturing Accounting.

* Appeal Board Case #20,166-49; affirmed by Appellate Division, Third Department, May 3, 1950.

"For the year 1946 appellant received a rate credit of $13,042.37 of which $287.69 was used.

"For the year 1947 a credit of $355.44 was issued to appellant of which $6.62 was used.

"On or about May 8, 1947 appellant filed a refund claim for $1,555.03 representing the unused portion of the credit issued to it in 1945. This claim was denied by the Commissioner on May 27, 1947 upon the ground that 'the Unemployment Insurance Law provides that the tax credit issued to an employer may only be used to pay contributions due for the four consecutive calendar quarters beginning July 1945 in your case.'

"On or about April 26, 1948 appellant filed a refund claim for $13,103.50, representing the unused portion of the credits issued in 1946 and 1947. This claim was denied by the Commissioner on June 10, 1948 on the ground that the statute makes no provision for a cash refund of unused credits.

"The pertinent provisions of the Unemployment Insurance Law are subdivision 6 of Sect. 570 and subdivision 4 of Sect. 577 which we quote:—

"Subdivision 6: 'Refunds and Credits. If an employer shall make application for refund of any contribution, interest or penalty paid by him or for a credit thereof and the commissioner shall determine that such contribution, interest or penalty, or any portion thereof was erroneously collected, the commissioner shall refund said amount or allow a credit therefor, without interest, out of the fund unless the employer shall have already deducted said amount by way of credit against moneys payable by him into the fund. No refund or credit shall be allowed unless an application therefor shall be made on or before whichever of the following dates shall be the later: (a) one year from the date on which such payment was made; or (b) three years from the last day of the first month following the end of that calendar quarter during which the remuneration was paid which formed the basis for contributions, interest or penalty claimed to have been erroneously collected. For a like cause and within the same period a refund may be so made or a credit allowed on the initiative of the commissioner.'

"Subdivision 4: 'Contribution Rate Credits. Notice, application and transfer of credits. (a) Each qualified employer shall, as soon as practicable after the effective date, be furnished a notice showing the amount of credit to which he is entitled. The amount shown on the notice may be applied against contributions which are payable on wages paid in the four consecutive calendar quarters beginning after the effective date, and reported not later than thirty days after the date prescribed by the commissioner for payment of contributions, on wages paid in the last of such quarters.'

"It is contended by appellant that there is nothing in the Unemployment Insurance Law which prohibits a cash refund of unused contribution rate credits and that hence the Industrial Commissioner has power to make such a refund. That argument overlooks the fact that we are dealing here with the right of a State officer to make refunds of taxes which were properly and lawfully collected. In the absence of specific authority authorizing such refunds the Industrial Commissioner is powerless to make them.

"It is noted that subdivision 4 of Sect. 577 provides that the amount of such contribution rate credits 'may be applied against contributions which are payable on wages paid in the four consecutive calendar quarters beginning after the effective date***.' For 1945 and 1946 the 'effective date' was July 1, (L. 1945, c.646). For 1947 and thereafter the 'effective date' date is September 30 (L. 1947, c.809). The appellant here was unable to use all its contribution rate credits for the years in question because of a sharp reduction in the number of employees employed by it. On January 1, 1945 appellant employed one thousand and four hundred and fourteen persons. This number was reduced so that as of December 31, 1947 it employed only one person.

"The statute provides only one method for the use of these contribution rate credits. They must be used in payment of contributions due during the four calendar quarters following the effective date mentioned in the statute. If they are not so used, the credit abates. The term 'may be applied,' as used in Sect. 577, subd. 4 (2) means 'must be applied.' (*Lincoln Candies Inc.* v. *Department of Labor,* 289 N. Y., 262, 266; *Hagadorn* v. *Raux,* 72 N. Y. 583, 586.)

"Appellant also asserts that the unused portion of the contribution rate credits constitutes an overpayment of the unemployment insurance tax by appellant. Section 570, subd. 6 permits refunds only in cases where the taxes have been 'erroneously collected.' There is no question in this case that the taxes, when paid, were justly due and owing. No claim is made by the appellant that said taxes were erroneously collected at the time they were paid. Under such circumstances, a refund is not permitted."

New York State Tax Clinic

Conducted by BENJAMIN HARROW, C.P.A.

Unincorporated Business—Real Estate

Any unincorporated business, trade, or occupation is subject to the Unincorporated Business Tax Law. The law (Secton 386) defining an unincorporated business subject to tax exempts an individual, partnership, or other entity that purchases and sells real property for his or its own account. The holding, leasing, and managing of real property is likewise not considered an unincorporated business. If such entity holds property primarily for sale to customers in the ordinary course of trade or business, the exemption does not apply. An individual otherwise engaged in the real estate business as, for example, one who earns commissions or brokerage fees as an agent, is subject to the tax. Where an individual earns commissions and also manages his own property or buys and sells property for his own account, it is the practice of the Commission to tax only the commission and brokerage income and to exclude any of the activities within the exempt provisions.

Where an individual is engaged in real estate activities within and without the state, he may allocate his income, provided he maintains an office without the state.

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Mr. Harrow has been a member of the American Institute of Accountants since 1922 and is a member of the New York Bar. He is now serving on the Society's Committee on Federal Taxation, and its Committee on State Taxation.

Mr. Harrow is engaged in practice as a certified public accountant and attorney in his own office in New York City.

Resident or Nonresident

A resident of New Jersey was engaged in real estate activities in New Jersey. He opened an office in New York and carried on business both in New York and New Jersey. Such an individual is subject to personal income tax as a nonresident on income derived from the business carried on in New York. He is also subject to the unincorporated business tax on business carried on within the state.

Suppose the individual rents a room in a New York hotel and resides in New York more than seven months during the year. Such an individual is taxed under the income tax law as a resident on all of his income, including the income earned in New Jersey. However, under the unincorporated business tax he would still be taxed only on New York income, since he maintains an office outside the state.

In the latter situation if the interests and associations of the individual are all connected with the New York residence, the individual may be considered a domiciled resident of New York. In such a case he would be subject to income tax on all of his income, the same as a nonresident maintaining a home in New York for more than seven months of the year. In addition his estate would be subject to the New York estate tax upon death.

Gain or Loss on Sale of Residence

Our State Tax Committee has been advocating the elimination of differences between the federal and state income tax laws. Two amendments to

the state law were proposed by the 1950 Legislature to eliminate two of these differences. One amendment would eliminate the adjustment for depreciation in determining the gain or loss on the sale of real property owned and occupied by a taxpayer as a residence. This was recently approved by the Governor. The other amendment was designed to eliminate the recognition of a capital loss on the sale of non-business or non-income-producing property. This was vetoed by the Governor. Unlike the federal rule, a taxpayer may still consider a loss on the sale of residence property as a capital loss, but the basis of the loss no longer need be adjusted for depreciation for the period of ownership.

The treatment of gains on the sale of residence property is still a troublesome one. We have in mind a common situation where a taxpayer sells his home at a profit and immediately purchases another home. It would seem more equitable to treat such a situation as non-taxable under a provision analogous to the involuntary conversion provisions under Section 354, particularly since a loss on such a sale is now not deductible. The non-taxability of such a gain should also apply where a new home is purchased within a specified time before the sale of the former home.

Real Estate Corporations

Section 198 of Article 9, relating to readjustment of accounts, has been revised and clarified. Within two years from the audit or statement of an account the corporation may file an application for a hearing. Thereafter, the Commission will send a notice of determination to the corporation. An overpayment of tax may be credited to the corporation or may be assigned to another corporation taxable under Article 9. To receive the credit, the assignee must file the assignment with the Commission. The revision permits the Commission to modify the penalty for failure to file the franchise tax report.

Doing Business

A Delaware corporation, a holding company, owns all the stock of a New York corporation. The Delaware corporation is not qualified to do business in New York. To what extent, if any, will the foreign corporation be deemed to be doing taxable business in New York. This situation frequently comes before the Tax Commission and is decided very much like a recent case that came before the Minnesota Court.[1] In itself, mere ownership of stock in a domestic corporation does not necessarily constitute doing business. In this case the Delaware corporation was organized for the purpose of controlling the election of officers and directors of the local corporation. A majority of the officers and directors of the local corporation were likewise its own officers. The foreign corporation maintained its office, books, and records and conducted all its activities in Minnesota to the exclusion of other states. The Court held that the foreign corporation was doing a taxable business in Minnesota.

Equitable Adjustment for Allocation

Section 210.8 of Article 9A gives the Tax Commission discretionary authority to adjust the allocation percentage. The 1950 Legislature amended this section by requiring the Tax Commission to publish *all* rulings of *general public interest* with respect to any application of the provisions of this section. This provision may not be as helpful to taxpayers as it sounds. The Tax Commission prefers to treat some situations as special and private. If the Tax Commission is to give such rulings publicity it will be more cautious and hesitant in relieving allocation hardships.

Basis for Determining Gain or Loss

One of our members poses an interesting situation. An individual while a non-resident of New York purchases

[1] *Minnesota Tribune Co. v. Com'r. Taxation* (1949); 37 N.W. 2d 737.

securities. Some time thereafter, the individual becomes a resident of the state and sells the securities at a profit. Is the basis for determining the gain the cost to the individual when, as a nonresident, he acquired it, or is it the market value of the securities at the time be became a resident?

The year of sale determines the liability for the tax and the Regulations (Article 491(a)) provide that gain in the usual situation is determined on the basis of the cost of the property. There is no provision in the law relating to the status of a taxpayer at the time he acquired the property as a factor in determining gain. If the property was acquired prior to January 1, 1919, the basis for determining a gain would be the cost or the fair market value as of January 1, 1919, whichever is higher, even though the individual was a nonresident on either or both dates.

Capital Gains—Sale or Exchange

The capital gain tax applies to gains resulting from the sale or exchange of property, but the words "sale or exchange" include other types of transactions as well (Section 350.15). A short sale of property is a sale or exchange. The transaction is completed when a purchase is made to cover the sale. A failure to exercise privileges or options to buy or sell property is a sale or exchange. The transaction is complete when the option expires. The retirement of corporate bonds and kindred obligations is a sale or exchange resulting in a capital gain or capital loss. That is true also of the retirement of stock, except where the redemption is deemed to be a distribution of a taxable dividend.

Securities, including bonds, stocks and rights, which are determined to be worthless during the taxable year are treated as a sale or exchange and the loss is deductible only as a capital loss. Liquidating dividends received in a complete or partial liquidation of a corporation are deemed to be a sale or exchange. In 1943, the legislature added to the list of transactions treated as a sale or exchange the voluntary abandonment of real property as worthless.

Alimony Payments

A husband who is a resident of the state may deduct alimony or separate maintenance payments, regardless of whether such amounts are includible in the gross income of his wife. A nonresident husband may deduct such payments only if the wife is taxable on such income, that is if she is a resident of the state (Section 360.17, Article 124 and Article 437).

Marital Deduction Act of 1950

The Governor has just approved a bill providing for a marital deduction in computing the net estate for purposes of the New York estate tax (Article 10c). Generally the provisions are quite similar to the marital deduction under the federal estate tax. The law becomes effective with respect to estates of decedents who die on or after October 1, 1950.

Under Section 249s(4) a deduction will now be allowed for any part of a deceased resident's estate which passes or has passed to the deceased's husband or wife. The deduction may not exceed 50% of the adjusted gross estate which is defined as the gross estate minus all the deductions allowed under Section 249a(1). These deductions consist of funeral expenses, administration expenses, claims against the estate, unpaid mortgages or other indebtedness against property included in the gross estate, and reasonable amounts expended for the support of dependents during settlement of the estate.

No marital deduction is allowed to a non-resident of New York. The status of the surviving spouse is determined as of the date of death. Like the federal law, the marital deduction is not allowed if the surviving spouse receives only a life interest or an interest which will terminate or fall upon the lapse of time. Patents, copyrights, and annuity contracts are terminable interests. But a life interest coupled with a power of

appointment in the wife exercisable in her favor or in favor of her estate makes the interest eligible for the marital deduction. A similar rule applies to proceeds of life insurance receivable in annual or more frequent installments. The spouse must receive all payments during her life and she must have a power of appointment over amounts payable after her death.

Both the federal and state law have a peculiar provision with respect to a disclaimer of a legacy. If the surviving spouse disclaims the legacy it may not be considered for the purpose of computing the marital deduction. If a legacy is disclaimed by a legatee in favor of the surviving spouse, it will nevertheless not be considered in computing the marital deduction.

Under Section 249s(2), no deduction will in the future (after October 1, 1950) be allowed for property acquired from a prior decedent spouse who died within five years prior to the death of decedent. Nor will the deduction be allowed for property acquired by gift from a spouse after April 2, 1948, the date of enactment of the 1948 Revenue Act. The purpose of this provision is to prevent two deductions, one for property previously taxed and the other for the marital deduction. Nevertheless, the provision with respect to property previously taxed applies even though no marital deduction was allowed in computing the net estate of the prior decedent.

The deduction for property previously taxed still applies in the case of estates of non-residents since the marital deduction is not allowed to non-residents.

To prevent an allowance of a double deduction, the $20,000 exemption from the first taxable bracket of $150,000 for property passing to a surviving spouse will be reduced by an equivalent amount of the marital deduction under new paragraph 4 of section 249s. A similar reduction in the insurance exemption is provided for where the insurance passes to a surviving spouse and to the extent that a marital deduction is attributable to such insurance.

The approval of the Marital Deduction Act of 1950 may result in some loss of revenue, but it will enable New York residents to obtain the full benefit of the federal marital deduction. The Bar Associations were strongly behind the law.

Extent of Power to Tax Interstate Commerce

A recent Circuit Court decision[2] appears to broaden the power of a state to tax corporations doing an interstate business. In this case a trucking corporation was engaged in the transportation of goods between states. It maintained terminals in Connecticut for local pick-up and delivery service incidental to its interstate business. The court approved an apportioned franchise tax against the corporation measured by net income. The corporation owned some office equipment in Connecticut. The trucks used in Connecticut for pick-ups and deliveries were leased. The tax attempted to reach the activities of the corporation in Connecticut and did not attempt to include activities outside the state. The activities in Connecticut produced some business within the state and net income attributable to such business was deemed to be properly taxable by Connecticut. The tax was held to be nondiscriminatory and not in violation of the commerce clause. If this decision is upheld by the United States Supreme Court, then any local incidents of interstate activity may be considered a valid basis for an apportioned tax on net income. At the present time a foreign corporation is not subject to the New York franchise tax if its only activity in New York is the solicitation of orders for its products, even if a sales office is maintained in New York for this purpose. The *Spector Motor Service* case, if upheld, would make such selling activities a proper basis for taxation. In Report

[2] *Spector Motor Service, Inc.* v. *O'Connor*, 2nd Circuit.

Bulletin 23 Prentice-Hall, Inc., in an excellent discussion of this case, says, "Thus, it is only realistic to believe that the distinction between 'exclusive' interstate business and other interstate businesses is destined for considerable narrowing, *if not total erasure in the income tax field.*" (italics ours)

Interstate Commerce and the Gross Receipts Tax

In upholding the Connecticut franchise tax asserted against *Spector Motor Service, Inc.,* Judge Clark said that the tax did not discriminate against nor burden interstate commerce. Would the decision have been the same if the tax had been on gross income or gross receipts? In that connection it should be noted that the New York City Gross Receipts tax is today applied in situations like the *Spector* case. Activity within the City is deemed a basis for the tax. For example, a firm of New Jersey accountants conducts an audit of the books of a client located in New York City. It has no office in New York. The Comptroller asserts that the receipts are subject to the tax. The Comptroller will permit an allocation of the receipts on a time basis and tax only that portion of the receipts representing payment for the New York activity. The solicitation of orders in New York City is a taxable activity under its rulings even though the taxpayer has no office in New York City. What happens to the once sacrosanct interstate commerce clause? If the *Spector* case is affirmed it may be whittled down to a mere historical place in a revered document.

Interstate Commerce— California Use Tax

On the altar of realism the states proceed to emasculate the once rock-ribbed interstate commerce clause. California recently upheld a use tax on all sales made within the state, including those solicited by mail order.[3] The West Publishing Company was not qualified to do intrastate business in California. It maintained so-called local offices in charge of local representatives. It employed salesmen in the state who solicited customers. The salesmen obtained and forwarded credit information concerning local customers, arranged for payment and collection of accounts, adjusted complaints. The West Publishing Company circularized advertising matter to members of the legal profession. The state contended that it provided a market for the West Publishing Company in competition with local law book publishers, and it provided the same protection to its salesmen that was afforded to salesmen carrying on business activities for a company engaged in intrastate business. Therefore, all of its California sales, those directly solicited and those resulting from mail orders, were subject to the Use Tax Act.

We recently discussed a Mississippi case[4] which held that an unqualified foreign corporation with no place of business within the State could not be made a collection agency for the Mississippi Use Tax.

Unemployment Insurance— Merit Rating

For several years employers received a credit that could be used only against current unemployment insurance taxes due. For the current year employers will not receive this credit for the reason that the reserve in the Unemployment Insurance Fund is at a low point. If an employer discontinued operations and was therefore no longer liable for the payment of unemployment insurance taxes he lost the credit. The credit could be transferred to a new employer if a business is sold to a new owner.

An interesting question came before the Division of Placement and Unemployment Insurance about a year ago. A corporation operated a restaurant until October 1, 1944. It then sold the

[3] *People of the State of California* v. *West Publishing Co.,* (Calif. Supreme Court).
[4] N. Y. State Tax Clinic, Feb. 1950, p. 120.

business, intending at that time to open another restaurant if it could find a suitable location. This it did six months later. In the meantime the corporation continued to file quarterly payroll reports for the fourth quarter of 1944 and the first quarter of 1945, but listed no employees for that period. The corporation claimed that it was entitled to the tax credit since the corporate entity was not dissolved and that it continued to be liable for various other taxes by reason of its continuance as a corporation.

The appeal board that heard the case held that when the employer corporation sold the restaurant it discontinued its operations within the meaning of Section 577.1(o) of the Unemployment Insurance Law, and that the statutory words "discontinued operations" should be given their commonly understood meaning. When an employer relinquishes its usual type of business activity by disposing of all or substantially all of its assets, it discontinues operations for tax credit purposes. Its intentions to resume activity at a later date are immaterial. At the moment of discontinuance it loses its right to be considered a "qualified employer." An inactive corporation is thus not regarded as operating a business and is not entitled to a tax credit. The new employer is however entitled to the credit.

Unemployment Insurance—Tips

Under the Unemployment Insurance Act an unemployed employee is entitled to benefits ranging from $10 to $26 per week for a maximum period of 26 weeks. The employer in computing the tax on wages must include the value of board and lodging furnished and tips. These are thus included in the basis of the tax and in the basis of unemployment insurance benefits. The Industrial Commissioner has set up a rule for determining the value of tips if no statement is made by the waiter to his employer as to the amount of gratuities received by him.

In a case heard before a referee, an employer had reported tips at a fixed amount in accordance with the rule promulgated by the Industrial Commissioner. When the employee applied for benefits under the Unemployment Insurance Tax Law he claimed that he had actually received tips substantially in excess of the amount fixed. He at no time had reported to his employer the amount of his gratuities nor did he make any certification with respect to them.

The employer had posted signs in the kitchen notifying waiters that they were privileged to certify the amount of tips received and, in the event no such certifications were made, the tips would then be fixed at a stated amount per day in accordance with the provisions of the rule set by the Industrial Commissioner. The referee held that the rule set up was not arbitrary or unreasonable and the rule precluded crediting the claimant with any tips in excess of those which had been reported by the employer. The fact that the unemployed waiter actually received more tips than those which were reported was held to be immaterial. The waiter could have received the full benefit of the tips if he had made a written certification of the actual tips received. Of course if he had done this he would have been subject to an income tax on the larger amount. In his apparent attempt to minimize his income taxes he lost out on the amount of his unemployment insurance benefits.

Franchise Taxes—Talk of Director Emery W. Burton

Allocation under the receipts factor —On March 23, 1950, Emery W. Burton, Director of the Corporation Tax Bureau, addressed a meeting of the Commerce and Industry Association on the subject of New York Franchise Taxes. Among other things he discussed the allocation of receipts in the case of cotton converters. Such corporations located in New York purchase greige goods and ship them to inde-

pendent finishing mills located outside of New York. The goods remain at the plant of the independent contractor where they are processed until the taxpayer issues instructions for shipping to the taxpayer's customers. The plant of the independent contractor is considered a regular place of business which permits the taxpayer to allocate under the property factor the goods located at the independent contractor's plant. But the plant of the independent contractor is not considered a permanent and continuous place of business of the taxpayer outside New York at the time of an appropriation of the goods to the order and, therefore, no allocation out of New York is permitted under the receipts factor.

Allocation for publishers of receipts from advertising and subscriptions—Deputy Commissioner Burton pointed out that the location of a subscriber is not a proper basis to measure the activities of a publisher in New York. If such a corporation has a permanent and continuous place of business outside the state, subscription receipts may be allocated to the permanent and continuous place of business where the subscription is accepted. Advertising receipts may be allocated to the place where the advertising contract is serviced.

Like the independent contractor in the case of a cotton converter, if a publisher uses an independent printer outside the state, the plant of the latter may be a regular place of business which would entitle the taxpayer to an allocation under the property factor for any paper or other property located at the plant of the independent printer.

Corporations in Joint Ventures—Allocation—Income from a joint venture of a corporation is included in the gross income of a corporation for franchise tax purposes. The joint venture itself is taxable under the unincorporated business tax, with the corporation's share of the income exempt from the tax because it will be subject to the franchise tax. In computing the franchise tax the property or wages of the joint venture are not includible in the allocation formula under the franchise tax law. The receipts from the joint venture however may be allocated to the place where the joint venture is carried on. The Tax Commissioner requires a copy of the joint venture agreement with the filing of the franchise tax report.

Inclusion of federal obligations in tax base—Commissioner Burton made some comments on the recent decision of the United States Supreme Court in the case of *New Jeresy Realty Title Insurance Co.* v. *Division of Tax Appeals.* He remarked that "some people seem to think that this decision would prevent New York State from including Federal obligations in the base of the franchise tax in determining a one mill tax." Commissioner Burton did not agree with this. He pointed out that the Supreme Court in the decision stated that it gave no consideration to the tax as a franchise levy. Commissioner Burton cautioned all corporations to continue including all government obligations in their assets for franchise tax purposes. Our opinion is in accord with Commissioner Burton's views as we indicated at length in the May issue of the New York State Tax Clinic.

The Shoptalkers

Conducted by Lewis Gluick, C.P.A.

The Shoptalkers Discuss Clients

There was a roar of laughter at one end of the table and the Shoptalker, from the other end, inquired the cause.

Star: The Kid just told a story, and there's no use repeating it. *You* couldn't print it.

Blank: Well, I have a story I'd like to see printed even though it isn't funny.

Sinbad: Spin it!

Blank: Well, my firm has had for several years a very rough and tough client. He is semi-retired, but he made his pile in a line that is no place for panty-waists. All we do is his tax work. This year, the first week in January, he gave us a lot of data, so we could make a final estimate. No more was heard from him for two months, so a secretary phoned him to bring in final figures. He made an appointment for March 7th at ten A.M.

At eleven that day his wife phoned. He was sick. We didn't question that. The man is a rough diamond, but not a liar. In fact, it was his health which caused him to curtail his activity. On March 14th he came in and furnished the necessary data—to *me*. He was a big shot in his line, and insists on dealing only with the higher-ups. I gave the file to my top tax man, who prepared the 1040. The chief of staff checked it. The head typist proof-read the typed returns. We *know* him, and we dare not make mistakes. A junior delivered it to his home that night.

Lewis Gluick, C.P.A., who has been a member of our Society since 1924, has resumed the practice of accountancy in the East.

Mr. Gluick, who had been writing under the name of The Shoptalker in other magazines since 1928, recently brought his group of Shoptalkers to our columns. We would welcome your acceptance of his invitation to participate in the discussions.

Next morning at nine he almost melted the phone wires. We had left out, he yelled, a capital gain item, and I'll wager the Kid's joke was more printable than his language. I persuaded him to come in, and he did, at eleven. It quickly developed that the "omitted" sale took place, January 4th of this year. Unmollified, he then produced a 1949 broker's statement on which he had been charged $13.00 interest. We had never seen it before. I argued it was only a trifle; that the mere labor *cost* of rewriting the return would be in excess of his tax-saving, even though he was in the 52% bracket. He blustered and blasphemed. It was a legal deduction and he meant to have it. So we let him have his way.

Oldtimer: He isn't unique, but fortunately not common. I hope you got paid.

Blank: That's the pay-off. We charged him twenty-five dollars more than the usual fee and he paid *us* without protest.

Shoptalker: You're lucky! But you sure earned it. Now take an experience I had tax week. A client gave me a lot of data, and I made up a return, showing an additional tax (over his estimates). He hit the ceiling. He was going home, houseclean his desk, and find more deductions. And by gosh! The next day he phoned more. Making no audit, and relying on the "information submitted" part of the declaration I sign, I recomputed the return. There was still a tax to pay. Again he fumed. Again he said he'd find more legal deductions. He didn't. But I didn't get anything extra for the re-write. In fact, he was reluctant to pay the basic fee. Seemed to hold me responsible.

Star: Did you see that Lew Lehr is dead?

Kid: Yes! Too bad!

Oldtimer: And why the change of subject?

Star: I'm right on point. He was

the comic who invented "Monkey's iss the cwaziest pipple."

Oldtimer: I get it! He never knew tax clients.

Everybody: (Laugh).

Oldtimer: As the oldest man present, I've probably had more than my share of such unreasonable people. But not all clients are like that, thank God. I remember one who had an additional assessment based on a return he had prepared himself. This was before Bercu had been heard of. So I went with him to a conference, cited case law to the Agent, and got him off, fairly and squarely, at a much reduced figure. He not only paid my fee, but with the check, payable to the firm, came a gift order for a new hat, drawn on Rogers Peet and payable to *me*.

Kid: And did you report that as taxable income?

Everybody: (Laugh).

Oldtimer: I took it as a gift, and since it was for only ten dollars didn't even file a 710.

Shoptalker: Laugh's on you, Kid. *That* goes in the Shop.

Kid: Okay! But have any of you seen the traveling saleswoman?

Shoptalker: Not yet, if you refer to Joan Davis' new picture. But I intend to.

Kid: So do I. But I mean a real one. I did. First one of the kind I'd ever met.

Oldtimer: Where have you been all these years? As far back as 1915 Edna Ferber was writing some good stories about a character named Emma McChesney.

Kid: So I've heard. But she's fiction. This babe is fact.

Sinbad: Spin it!

Kid: She's a sister to one of our regular clients. Just visiting here, but realizing she had to make a return, asked her brother, and he sent her to us. Danged if she didn't bring in the most beautiful detailed record of travel and entertainment expense I've ever seen a commission salesman produce. As neat as her figure.

Shoptalker: And I'll bet that her taxable net income was pitifully small. As I remarked last month, sales ability and bookkeeping just don't go together.

Kid: You're so right! But to get back to the first question. How many of you have made returns for *traveling saleswomen*?

Everybody: (Silence)

Kid: See what I mean. They *are* rare.

Sinbad: I've got a realtor of the opposite sex, and she is a dilly. She sells, but her only travel is within county limits, and she won't understand that commuting expenses are not deductible. Every year I'm worn out after convincing her that, no matter how unjust the law is, I won't be party to claiming a deduction that can't be maintained.

Law: May I interpose something?

Kid: You may *put in* something, but not interpose.

Law: Okay! May I proceed, or must I go ahead?

Kid: Pray do!

(Law feinted at throwing a coffee cup at the Kid and then resumed).

Law: During 1949 I finally won a case that took longer than any case I've ever fought. Up to the highest state court; remanded back for retrial; then up again to the top—and victory. My client got, claim plus interest over $80,000 and I got my fair share. Naturally, I reported it under Section 107. The client's claim had been based on personal services, so I advised him to use 107 also. He agreed. Then brought me his data. Be blowed if he could stretch the actual earning period to a full 36 months. By a margin of less than thirty days, he has to go into the 57.2 bracket for 1949.

Shoptalker: Very sad.

Oldtimer: Shoptalker, would you do us a favor?

Shoptalker: Certainly.

Oldtimer: Tell your public that this lunch club meets on Tuesday now and that, if we can get a little more interest, we will establish an uptown branch.

Shoptalker: It's a pleasure.

Oldtimer: Thanks!

Protect Thyself

By Thomas W. Byrnes, C.P.A.

The periodicals and the annual reports of accounting societies indicate important advances in the numbers of young persons attracted to the accounting profession during recent years. In view of this interest in a fascinating vocation, it may be not amiss to pass along a word or two of caution to the neophytes to save them possible future embarrassment.

Students of schools of business administration are taught the theory and practice of accounting, auditing, and allied subjects. Graduating, they go forth to preach the gospel of accurate recording and reporting, and in the course of their work they often run afoul of happenings which are not in accord with the ethical principles which should prevail in all transactions. Errors of omission and commission also come to light, and as an engagement progresses possibilities for improvements in accounting and other procedures, weaknesses in adherence to prescribed routines in internal control, etc., are often observed and recorded. The disagreement with unethical practices, the corrections of errors, and the suggestions for system changes are usually discussed while the audit is in progress. These discussions and others of importance may lead to an auditor's later confusion unless careful notations of each item are made at the time of discovery and observation, dated, and acknowledged by the signature of the client's representative to whom they were referred. There have been instances where representatives subsequently denied all knowledge of such discussions when a higher executive took to task the authorizing person. If the latter had merely approved orally, the auditor, lacking a signature, in such cases would be in an awkward position.

Thomas W. Byrnes, C.P.A., has been a member of the Society since 1911, and is a Certified Public Accountant of New York and New Jersey. He is also a member of the American Institute of Accountants.

Mr. Byrnes is a consultant to the accounting firm of Byrnes and Baker, C.P.A's. He was formerly an associate professor of accounting at Columbia University. He is a co-author of the text entitled, "Auditing."

The value of complete data in an auditor's file is illustrated by the following: In the examination of a small institution an apparent shortage was disclosed. The superintendent, through whose hands all funds passed, had a quaint method of depositing all receipts in his personal bank account. He reported and remitted to the cashier-bookkeeper only the items called for by the latter when weekly the two of them "made cash." When asked by the auditor about the unaccounted for items, the superintendent produced a list which corresponded in all details with that of the auditor, and at the latter's suggestion at once drew his personal check—which was promptly deposited—for the total. About two years later, the State investigated the institution and the State's auditor found the same shortage, but did not continue the examination to the date of the deposit. The original auditor, called as a witness, produced his work papers and was able to show the date, cashbook page, details, and the deposit of the amount in question. The auditor's records absolved the superintendent of the charge of dishonesty but not of improper business methods. Had the auditor relied merely on his memory, or if he or his work papers had not been available at the time of the trial, it might have ap-

peared as though he had been negligent in his audit.

The practitioner cannot be too careful when in possession of and inspecting the property of clients. Items such as cash, notes, securities, insurance policies, etc., should be counted, examined and listed only in the presence of a client-designated representative, usually the custodian, and a receipt should be taken when the examination is completed. The auditor should not permit a custodian to leave him until the work in hand is completed. If an interruption is necessary, the entire subject matter should be locked and kept under dual control of the auditor and the custodian until the latter's return. Failure to observe this precaution has brought grief to many auditors, particularly in examinations of financial concerns.

When it is necessary to retain an important record pending completion of its audit, care should be observed to prevent tampering with it over night. For protection, if an independent vault has not been assigned to the auditors, the retained book or books should be sealed. To obscure the figures on the dial, if a safe is available, metal clamps are used which fit over the combination's dial and are held in place by the auditor's lock. If the compartment is key-locked, two keys obtainable from any safe manufacturer can be inserted to prevent opening unless the auditor's holding lock is released. If neither private vault nor private safe is available, the retained records should be wrapped in paper, bound with wire, and the auditor's metal and impression seals affixed before placing in the office safe. The next morning all wrappings should be carefully examined.

No documents should be taken from a client's office. If retention is necessary to prove falsification or for any other purpose, the documents should be placed in the hands of an authorized officer after copies have been made for the auditor's files.

A friendly attitude should be maintained with the client's employees, but familiarity should be avoided.

The foregoing matters are merely suggestions which will bring to mind many other precautions to be exercised by auditors, who should also keep mentally before them at all times the admonition: NEVER TAKE ANYTHING FOR GRANTED.

OFFICIAL DECISIONS *and* RELEASES

THE following questions and answers have been excerpted from the proceedings of the recent meeting sponsored by the New York State Society of Certified Public Accountants and the New York State Board of C.P.A. Examiners. It is believed that they will be of interest and assistance to candidates for the C.P.A. certificate. Candidates desiring answers to specific questions should address them to Mr. John R. Wilkinson, Executive Secretary, New York State Board of C.P.A. Examiners, 23 South Pearl St., Albany 7, New York.

Question: Is C.P.A. experience with an out-of-State C.P.A., who also holds a New York certificate, acceptable toward the three-year requirement?

Mr. Lubin: The answer is yes.

Question: What procedure is followed in requesting a review of an examination paper? How does this review affect any subsequent examination in the same subject?

Mr. Lubin: A candidate who desires a review of an examination paper should forward a written request to the Executive Secretary of the C.P.A. Board in Albany. If the next examination is held before he obtains a response, he should take the examination. If upon review the appealed paper is passed, the passing grade will stand regardless of the results in the new examination. A subsequent failure will not affect a passing grade assigned to an appealed paper.

Question: May the answers to problems be prepared in pencil?

Mr. Lubin: In New York State only the work papers may be prepared in pencil. Handbook 14 of the Board, (page 40) reads as follows: "Papers are to be written on one side only and in ink, except that in Practical Accounting working papers (but not statements) may be in pencil." I note that the booklet, "The C.P.A. Examination—Gateway to a Profession", published by the American Institute of Accountants, reads "Answers may be written in pencil or in ink." However, in New York State they must be in ink and not pencil, except insofar as the work papers are concerned.

Question: Will an applicant who has not fulfilled his experience requirement at the time of filing his application, but who will have it completed before the date of the examination, be permitted to sit for the Practical Accounting examination?

Mr. Lubin: That's a good question. We often have applicants who are short two or three months of having their three years of experience at the time of filing for the examination, but who expect to complete this requirement before the taking of the examination. If your employer will submit a notarized statement to the effect that he expects to retain you in his employ for the next two or three months—meaning up to the date of examination—and will agree to notify the Board of any termination in such employment for any reason whatsoever, we will extend the period and give you credit. We call such a person a "conditional candidate." We give him permission to take the examination, but only with the understanding that he will submit a properly drawn up and attested letter to the effect that he has completed the "shortage" of experience prior to the date of the examination.

Question: Should working papers be turned in with the answer paper?

Mr. Lubin: There is a Departmental ruling, to the effect that you cannot walk out of the examination room with working papers; you have to hand them to the proctor. Therefore, turn in all work papers with your answer papers; then you comply with the Department's requirement. You are not going to be

penalized for giving more data than is required. Then, too, the working papers are sometimes consulted when an arithmetical error has been made, to ascertain whether the candidate possesses knowledge of the principles involved.

Question: Would you clarify that answer about a work sheet which is called for as the final requirement of a problem? Must it be written in ink?

Mr. Lubin: This is my understanding: Work papers (which mean the papers like "T" accounts and whatever else you use to arrive at the answer that is requested) may be in pencil. But if the question reads, "Submit a work sheet," you must submit that in ink. In other words, write the requested answer in ink, but the supporting data may be submitted in pencil.

Question: How much weight is given to the correct application of principles? How much to arithmetical accuracy? For example, suppose that a percentage—incorrectly figured—gives a wrong solution, but the correct principles are applied in the solution. How will the problem be graded?

Mr. McKeon: Naturally, something is taken off for mathematical error, but if a man knows his subject and indicates it from the way he answers, the question is given a passing grade; without a doubt he would be failed on something more than a mere mathematical error.

Question: Will experience obtained concurrently with an accounting degree, if on a full-time basis, be acceptable for the examination on Practical Accounting?

Mr. McKeon: If a man is studying at college at night and is working all day, full time, he gets full credit. On the other hand, if he is going to college during the day and doing part-time work at night or odd jobs, he is *not* given credit.

Question: If you are qualified to take four parts of the examination, must you take all four parts at one sitting?

Mr. Thomy: No, you must take only the three so-called "Theory" parts of the examination (Accounting Theory, Commercial Law, and Auditing) at one sitting. Taking Practical Accounting is an election.

Mr. Kane: There are about half-a-dozen of these questions here dealing with the inclusion in the examination of a specialized subject, such as governmental accounting or brokerage accounting, which many practitioners do not encounter in their practice. Since most of them deal with municipal accounting, I will answer that part in this way: the principles of fund accounting that are used in governmental accounts are no different from those used in the accounts of an organization such as The New York State Society of Certified Public Accountants, the American Institute, any club, any fraternal organization, any church, hospitals, schools, etc. In other words, there is a large area of accounting of which governmental accounts—or, as we call them, fund accounts—are typical. In my opinion they constitute such a large area of accounting as to justify considerable emphasis thereon in the examination. Even though the emphasis may appear to be mostly on the municipal accounting questions, it is, in fact, upon fund accounting in general, which is a very large area of accounting.

A question also dealt with cost accounting in specialized areas. Cost accounting is vital to the determination of inventories in a manufacturing business. The auditor is responsible for doing some work in connection with the evaluation of inventories, and to do that he must have some knowledge of cost accounting.

This whole area of specialized accounting is a matter of definition. If you do lots of work in the field of taxes, that is the area in which you would like to see the questions. If you work with manufacturing cost, that is not a specialized area for you. The subject matter of these examinations cannot be restricted solely to the areas in which a particular candidate has had actual experience.

Contemporary Practices in Costing Inventories

(Continued from page 354)

Conclusion

In conclusion it may be said that the differences in accounting procedures which have been observed in studies like these I have described reflect, to a large degree, differences in operating methods and management of the individual companies. In some companies costs are used primarily to aid management in operating control, in other companies costs are wanted principally for pricing, and in still other cases the processes of cost accounting are guided by and largely confined to accumulation of data needed for financial reports. The costs and costing methods which best serve one of these purposes are not necessarily equally suitable for other purposes.

While greater uniformity would doubtless facilitate the work of the accountant engaged in public practice, efforts to achieve such uniformity should not neglect the advantages which accrue to each company from fitting its accounting plan to its own needs. There is already evidence enough to indicate that some of the apparent variability of reported income is due to accounting conventions which do not always reflect the facts about the true incidence of costs. Hence it seems that there can be no substitute for study of the methods of costing employed and the conditions under which they are used as a basis for evaluating the resulting inventory figures.

Book Reviews

(Continued from page 327)

tices sometimes found. Informative comments under these headings appear and, at least in most cases, the examples selected are informative and of value to those for whom the book was prepared.

In the opinion of this reviewer the book may be accepted as meeting the two specific purposes quoted earlier herein which the author had in mind in its preparation. It is a contribution to current accounting literature in this respect although it does not purport to contain any contribution of knowledge not existing previous to the publication. It is more nearly a compilation, but a useful one.

Gordon M. Hill

Brokerage Accounting

By Homer St. Clair Pace and Edward J. Koestler. Pace & Pace, New York, N. Y., 1950. Pages: v + 188; $5.00.

The scope of the book goes far beyond that indicated by the title. The history and background of organized security and commodity markets is developed at length. This follows through to present day regulations by the U. S. Government and the more important exchanges.

The treatment of the subject is ideal in that the authors supply meaning and purpose to bookkeeping practices by first describing the operational procedures necessitated by the many phases of the security and commodity brokerage business and then describing the records which give appropriate expression to the procedures. At each point the explanation is followed by an illustration of the form in use. The book is replete with transcripts of federal and exchange rules and regulations which influence the bookkeeping and accounting. However, no reference is made to S. E. C. rule X-17A-3 which stipulates minimum records required and X-17A-4 which specifies the holding period.

The presentation of the material follows a natural subdivision into stock brokerage principles and procedure in Section I, and commodity brokerage principles and procedure in Section II.

The preparation of financial reports and statements is developed in Section III. This is a very able treatise which concludes with a specimen response to a New York Stock Exchange financial questionnaire which covers more situations than would ordinarily be encountered.

The book is an excellent text and training manual. The addition of an index would enhance its value as a reference book.

Charles Vonhausen

New York, N. Y.

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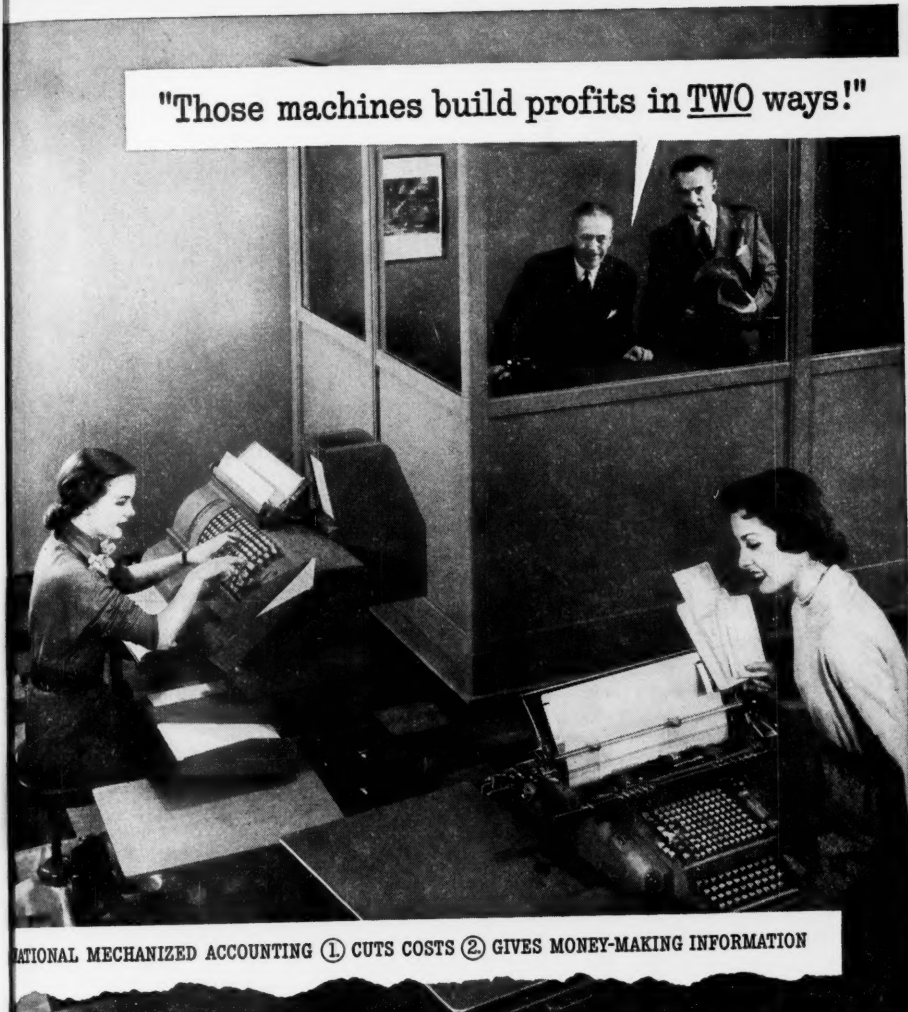
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